

5-15-2007

Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line

Stefan J. Padfield

Follow this and additional works at: <http://digitalcommons.pepperdine.edu/plr>



Part of the [Securities Law Commons](#)

Recommended Citation

Stefan J. Padfield *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 Pepp. L. Rev. 4 (2007)

Available at: <http://digitalcommons.pepperdine.edu/plr/vol34/iss4/9>

This Article is brought to you for free and open access by the School of Law at Pepperdine Digital Commons. It has been accepted for inclusion in Pepperdine Law Review by an authorized administrator of Pepperdine Digital Commons. For more information, please contact Kevin.Miller3@pepperdine.edu.

Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line

Stefan J. Padfield*

- I. INTRODUCTION
- II. BACKGROUND
 - A. *Materiality*
 - B. *Reliance*
 - C. *Scienter, Loss Causation & Heightened Pleading Standards*
- III. OVERVIEW OF THE PROBLEM AND PROPOSED SOLUTION
 - A. *The Problem*
 - B. *The Proposed Solution*
- IV. APPLICATION OF THE PROPOSED SOLUTION TO RELEVANT CASE LAW
 - A. *The "Proximately Disclosed" Cases*
 - B. *The "Dispersed Data" Cases*
 - C. *The Corrective Disclosure Cases*
 - D. *The Delayed Reaction Cases*
- V. CONCLUSION

* Assistant Professor, University of Akron School of Law. B.A., Brown University; J.D., University of Kansas. I would like to thank the University of Akron School of Law for providing me with a summer research grant to complete this project. This paper was presented at the Seventh Ohio Legal Scholars Workshop, held at Case Western Reserve University School of Law on June 23, 2006. My thanks to all the participants for their helpful comments. In particular, I would like to thank Regina Burch, Assistant Professor, Capital University Law School, who led the discussion and provided many helpful comments of her own. In addition, I would like to thank Professor Willa Gibson of the University of Akron School of Law for her helpful comments.

I. INTRODUCTION

Corporations sometimes tread a fine line between adequate and inadequate disclosure under the securities laws by disclosing the data necessary to calculate the bottom line impact of a particular set of facts, but failing to disclose the bottom line itself. For example, in one particular case, Merck & Co., Inc. (“Merck”) disclosed that one of its subsidiaries, Medco Health Solutions, Inc. (“Medco”), had recognized co-payments it never actually received as revenue.¹ Merck failed, however, to disclose the total amount of the revenue so recognized—which turned out to be \$5.54 billion for the year 2001.² When plaintiffs sued, claiming that recognition of this never-received revenue constituted fraud, the Third Circuit granted Merck’s motion to dismiss on the ground that the revenue recognition practice was immaterial as demonstrated by the market’s failure to react to disclosure of the practice.³ As for the argument that the disclosure of the revenue recognition practice was materially deficient for failing to disclose the total amount of revenue recognized thereunder, the court held the omission of the bottom line to be immaterial as well, since the data necessary to calculate the amount had been disclosed.⁴ The court noted, however, that “Merck was clearly treading a fine line with this delayed, piecemeal disclosure.”⁵

When plaintiffs challenge such incomplete disclosure as fraudulent, courts routinely dismiss their claims based upon application of what, for the purposes of this paper, I will call the “Simple Math” rule. Under the Simple Math rule, courts “decline to hold that those responsible for the preparation of [disclosures] must assume that stockholders cannot perform simple [math].”⁶ In other words, failure to disclose the bottom line is immaterial as a matter of law where the data necessary to calculate the bottom line has been disclosed. The Third Circuit relied on the Simple Math rule in Merck’s case, even though Merck also failed to disclose one of the necessary pieces of data to allow for calculation of the bottom line.⁷ The Third Circuit concluded that since the missing piece of data could readily be surmised by making one simple assumption, the case did not differ significantly from other cases that have concluded that requiring investors to perform mathematical calculations to determine the impact of certain facts did not amount to securities fraud.⁸ The court left open, however, the question of

1. *In re Merck & Co., Sec. Litig.*, 432 F.3d 261, 264 (3d Cir. 2005).

2. *Id.* at 264-65.

3. *Id.* at 269-70.

4. *Id.* at 270. The court framed the issue as “whether needing [a certain] amount of mathematical proficiency to make sense of the disclosure negates the disclosure itself.” *Id.*

5. *Id.* at 271.

6. *Ash v. LFE Corp.*, 525 F.2d 215, 219 (3d Cir. 1975).

7. *Merck*, 432 F.3d at 270.

8. *Id.*

“how many mathematical calculations are too many or how strained assumptions must be” before such piecemeal disclosure constitutes fraud.⁹

In this paper I address the question left open by the Third Circuit in *In re Merck & Co., Securities Litigation*. I argue that the current disclosure regime’s express purpose of ensuring full and fair disclosure cautions against courts being too quick to dismiss claims based upon a failure to disclose the bottom line. Rather, courts should apply what I call, for purposes of this paper, the “Reasonably Available Data” rule.¹⁰ The Reasonably Available Data rule builds upon existing materiality doctrines to analyze each particular omission on its own facts.¹¹ Specifically, I argue that when courts are presented with the question of whether failure to explicitly disclose the bottom line constitutes a material omission, they should ask: (1) whether all the relevant pieces of data necessary to calculate the bottom line were disclosed proximately to one another and in the place where a reasonable investor would expect to find them; (2) whether the data was cross-referenced to; and (3) whether the import of the data was sufficiently highlighted to alert the reasonable investor.¹² In addition, where the bottom line was omitted in a corrective disclosure, that fact should count against defendants.¹³ Finally, a presumption of materiality should be applied where the bottom line is subsequently made public and the market reacts negatively to that disclosure.¹⁴

This approach is consistent with the Supreme Court’s admonition against the use of bright-line rules in the context of materiality determinations:

A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress’ policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive.¹⁵

9. *Id.* at 271.

10. *See infra* notes 122-30 and accompanying text.

11. *See infra* pp. 962-64.

12. *See infra* pp. 963-64.

13. *See infra* p. 964.

14. *See infra* note 129 and accompanying text.

15. *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 (1988); *see also Ganino v. Citizens Utils. Co.*, 228

It is my contention that the bright-line Simple Math rule, which designates the single fact of calculability as determinative of immateriality, creates exactly the type of underinclusive results the Supreme Court warned of. Furthermore, the proposed approach makes sense from a policy standpoint because it continues to serve the safety valve function of the Simple Math rule by allowing courts to dismiss frivolous claims, while avoiding the watering down of a materiality standard that is so integral to our modern disclosure regime.

Following this Introduction, Part II will provide relevant background and discuss the elements of Rule 10b-5,¹⁶ which is the anti-fraud provision most often relied on by investors.¹⁷ This section will also include a discussion of the relevant factors important under various materiality doctrines, such as the “hidden facts” doctrine and the “bespeaks caution” doctrine.¹⁸ Part III will provide a more detailed explanation of why there is a problem with courts applying a general rule that failure to do calculations for investors does not constitute a material omission as a matter of law, and presents the Reasonably Available Data rule as a possible solution.¹⁹ Part IV then applies the Reasonably Available Data rule to relevant case law, demonstrating that the rule produces results more in line with the Supreme Court’s definition of materiality, and better serves the goals of our current regulatory regime, than the Simple Math rule.²⁰ Finally, Part V provides concluding remarks.²¹

F.3d 154, 162 (2d Cir. 2000) (“Following *Basic*, we have consistently rejected a formulaic approach to assessing the materiality of an alleged misrepresentation.”).

16. A number of the cases discussed in this paper arose under Rule 14a-9, which prohibits material misstatements and omissions in connection with the solicitation of proxies. See 17 C.F.R. § 240.14a-9 (2006). However, since this paper is focused on the issue of materiality, this distinction is of little import since “[t]he concept of materiality under the proxy rules is much the same as under the securities laws generally.” THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* 371 (5th ed. 2005). This is not to say, however, that one could not argue that some factual distinction between the solicitation of proxies and the sale of securities warrants some type of modification of the proposed Reasonably Available Data rule in the relevant context. Such fine-tuning of the Reasonably Available Data rule, however, is beyond the scope of this article.

17. See *infra* notes 22-105 and accompanying text.

18. See *infra* notes 22-105 and accompanying text.

19. See *infra* notes 106-30 and accompanying text. It is not difficult to foresee continued problems with corporations failing to disclose the bottom line. See David Reilly, *Restatements Still Bedevil Firms*, WALL ST. J., Feb. 12, 2007, at C7 (“Publicly traded companies filed 1,876 restatements of financial results in 2006, setting a record for corrections of financial statements while showing that many still are struggling to get the accounting right for both simple and complex transactions.”); David Reilly, *No More ‘Stealth Restating’*, WALL ST. J., Sept. 21, 2006, at C1 (“In recent years, scores of companies have changed previously reported figures via what critics call ‘stealth restatements,’ commonly including the new, different figures in subsequent securities filings. The SEC’s stand: Such changes constitute information that is material to investors and thus needs to be formally disclosed in a restatement filing clearly labeled as such.”).

20. See *infra* notes 131-278 and accompanying text.

21. See *infra* notes 279-80 and accompanying text.

II. BACKGROUND

"The starting point in analyzing any question of federal securities law is of course the statutes."²² The two main statutes making up federal securities law are the Securities Act of 1933²³ ("the Securities Act" or "the '33 Act") and the Securities Exchange Act of 1934²⁴ ("the Exchange Act" or "the '34 Act," and, together with the '33 Act, "the Acts"). The Securities Act focuses on the registration and distribution of securities.²⁵ Meanwhile, the Exchange Act sets forth, among other things, the on-going and periodic reporting requirements of issuers registered under the '34 Act.²⁶ Meanwhile, the Securities and Exchange Commission ("SEC"), the regulatory body that administers the Acts, issues various rules to give further effect to the statutory provisions of the Acts.²⁷ Finally, judicial opinions round out the primary sources of securities law.²⁸

The broad goal of securities regulation in the United States is to ensure full and fair disclosure:

Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." H. R. Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934). Th[e Supreme] Court "repeatedly has described the 'fundamental purpose' of the [Exchange] Act as implementing a 'philosophy of full disclosure.'" *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 477-478 (1977), quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963).²⁹

Full and fair disclosure is essential to the integrity of the securities markets,³⁰ and Rule 10b-5, the general antifraud provision promulgated by

22. HAZEN, *supra* note 16, at 3.

23. 15 U.S.C. § 77a (2000).

24. 15 U.S.C. § 78a (2000).

25. HAZEN, *supra* note 16, at 29-30.

26. *Id.* at 30-31.

27. *Id.* at 32.

28. *Id.* at 3 n.31 ("[T]he essence of most securities litigation is grounded upon SEC Rule 10b-5, which is very brief and sketchy. Thus, it is fair to say that the vast body of case law under this section is a type of de facto federal common law of securities fraud.").

29. *Basic, Inc. v. Levinson*, 485 U.S. 224, 230 (1987).

30. *See id.* at 234-35 n.12 ("The importance of accurate and complete issuer disclosure to the integrity of the securities markets cannot be overemphasized. To the extent that investors cannot rely upon the accuracy and completeness of issuer statements, they will be less likely to invest,

the SEC pursuant to § 10 of the Exchange Act, is an essential component of this disclosure regime.³¹

In relevant part, Rule 10b-5 makes it unlawful for anyone, in connection with the purchase or sale of a security, “to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”³² The elements of Rule 10b-5 include: (1) a false material representation, or omission of a material fact necessary in order to make a statement made not misleading;³³ (2) made or omitted with scienter; (3) that is relied upon and causes loss.³⁴ Because the Simple Math rule states that failure to disclose the bottom line is immaterial as a matter of law where the data necessary to calculate that bottom line is disclosed, the element of particular relevance to our discussion here is materiality. However, I will also address some of the other elements because there is often a significant blending of factors in the reported cases.

Before continuing on to the discussion of the relevant elements of Rule 10b-5, however, it is worth quickly reviewing some other liability provisions under the Acts that contain a materiality element, since the discussion here regarding materiality should apply equally under these other sections. These provisions include: Section 11(a) of the Securities Act,³⁵ which “creates an express right of action for damages by securities purchasers when a registration statement contains untrue statements of material fact or omissions of material fact;”³⁶ Section 12(a)(2) of the ‘33 Act,³⁷ which

thereby reducing the liquidity of the securities markets to the detriment of investors and issuers alike.” (quoting *In re Carnation Co.*, Exchange Act Release No. 22214 (1985)).

31. *Basic*, 485 U.S. at 231 (“[A] private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act’s requirements.”).

32. 17 C.F.R. § 240.10b-5 (2006).

33. This paper argues; in effect, for an affirmative duty to disclose the bottom line impact, where material, of otherwise disclosed facts. See *In re Time Warner, Inc. Sec. Litig.*, 9 F.3d 259, 267 (2d Cir. 1993) (“[A]n omission is actionable under the securities laws only when the corporation is subject to a duty to disclose the omitted facts.”). One basis for explicitly recognizing such a duty is that a statement disclosing a particular fact without disclosing the relevant impact creates the impression that the consequences of that fact are insignificant. On its face, recognizing such a duty is not a startling proposition. See *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 777 (2d Cir. 1991) (“That inside directors stand to gain from a recommended transaction is material information that must be disclosed to shareholders considering a tender offer. Moreover, we may assume for purposes of our decision that there is a reasonable likelihood that the magnitude of such a gain would be considered important by the reasonable investor in deciding how to act and is thus also material information.”) (internal citation omitted). It is a particularly non-controversial proposition in light of the fact that I do not challenge the current judicial approach to the extent it allows companies to satisfy this duty by providing investors with sufficient data to calculate the magnitude themselves. Rather, I argue simply that a more rigorous analysis needs to be applied in these cases in order to ensure that the principle of full and fair disclosure is upheld.

34. *Starr v. Georeson S’holder, Inc.*, 412 F.3d 103, 109 (2d Cir. 2005).

35. 15 U.S.C. § 77k (2000).

36. *HAZEN*, *supra* note 16, at 284.

37. 15 U.S.C. § 771(a)(2)(2000).

“creates an express private remedy for material misstatements or omissions in connection with the sale or offer for sale of a security;”³⁸ Section 17(a),³⁹ which “prohibits fraud, material misstatements, and omissions of fact in connection with the sale of securities;”⁴⁰ Rule 14a-9,⁴¹ which “prohibits material misstatements and omissions in connection with the solicitation of proxies;”⁴² and, Section 14(e) of the Exchange Act,⁴³ which “prohibits material misstatements, omissions, and fraudulent practices in connection with tender offers.”⁴⁴ There are obviously many meaningful differences among these provisions. For example, not all of them require a showing of reliance or scienter, or support a private cause of action.⁴⁵ However, materiality is generally analyzed similarly under all these provisions.⁴⁶ It is to this particular element that we turn next.

A. Materiality

The Supreme Court defined materiality for purposes of securities regulation in *TSC Industries, Inc. v. Northway, Inc.*⁴⁷ There, the Court stated that “[a]n omitted fact is material if there is a substantial likelihood that a reasonable [investor] would consider it important in deciding [whether to buy or sell].”⁴⁸ However, “it is not necessary to show that the investor

38. HAZEN, *supra* note 16, at 302.

39. 15 U.S.C. § 77q (2000).

40. HAZEN, *supra* note 16, at 308.

41. 17 C.F.R. § 240.14a-9 (2006).

42. HAZEN, *supra* note 16, at 368.

43. 15 U.S.C. § 78n(e) (2000).

44. HAZEN, *supra* note 16, at 412.

45. See, e.g., *id.* at 303 (“[S]ection 12(a)(2) liability does not require scienter.”); *id.* at 304 (“[I]t is not necessary for plaintiff to establish reliance in a section 12(a)(2) action.”); *id.* at 309 (“The overwhelming majority of recent decisions have not been at all receptive to the private right of action [under section 17(a)].”); *id.* at 370 (“[S]cienter is not required to establish a violation of Rule 14a-9’s prohibitions against material misstatements and omissions in connection with a proxy solicitation.”).

46. See *id.* at 284 n.3 (“Normal concepts of materiality apply in section 11 actions. . . . Thus, for example, the bespeaks caution doctrine . . . is applicable”); *id.* at 302 n.2 (“[M]ateriality is the same under sections 11 and 12(a)(2) of the 1933 Act.”); *id.* at 413 (“Materiality issues under the Williams Act are to be decided in much the same way as under the other disclosure provisions of the securities laws.”).

47. 426 U.S. 438 (1976). *TSC Industries* involved a proxy statement claim brought under Rule 14a-9, but the *TSC* standard for materiality has been adopted in Rule 10b-5 cases as well. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988) (adopting the standard in *TSC Industries* for Rule 10b-5 actions); see also *Mills v. Elec. Auto-Lite Co.*, 396 U.S. 375, 384 (1970) (stating that materiality “embodies a conclusion that the defect was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote”).

48. *TSC Indus.*, 426 U.S. at 449.

would have acted differently.”⁴⁹ The Court also defined materiality as involving an evaluation of whether there was “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁵⁰

“The ‘total mix’ of information includes all information ‘reasonably available to the shareholders,’ including ‘data sent to shareholders by a company.’”⁵¹ In order for information to be “reasonably available” so as to make up part of the total mix of information available to a reasonable investor, courts sometimes require some type of cross-reference from the document to which an investor can be expected to look, to the source of any document a defendant is relying on in arguing all necessary information was disclosed.⁵² Also, under the total mix of information analysis, public availability of the truth may offset a misleading disclosure.⁵³ However, “not every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow.”⁵⁴ In line with this reasoning, a defendant cannot rebut a charge of having omitted a necessary material fact by pointing to facts that, while disclosed and

49. HAZEN, *supra* note 16, at 487; *see also* TSC Indus., 426 U.S. at 449 (“[Materiality] does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote.”).

50. TSC Indus., 426 U.S. at 449.

51. Starr v. Georgeson S’holder, Inc., 412 F.3d 103, 110 (2d Cir. 2005) (quoting Press v. Quick & Reilly, Inc., 218 F.3d 121, 130 (2d Cir. 2000)).

52. *See* United Paperworkers Int’l Union v. Int’l Paper Co., 985 F.2d 1190, 1199-1200 (2d Cir. 1993) (“Nor was the Company’s 10-K Report part of the reasonably available mix. That report was filed with the SEC, not distributed to shareholders. Nothing in any of the documents sent to shareholders highlighted the 10-K Report. The Proxy Statement did not mention it at all; and the annual report made no reference to it in its description of the Company’s environmental record. Indeed, in each link of the chain of references on which the Company now relies the pertinent reference was a general one widely separated from any environmental discussion. Thus, the Proxy Statement’s mention of the annual report appeared only as a general reference on page 2 of the Proxy Statement; the annual report’s reference to the availability of the 10-K Report appeared only as an unenlightening statement on the inside of the annual report’s back cover[.]”); Marksman Partners, L.P. v. Chantal Pharm. Corp., 927 F. Supp. 1297, 1307 (C.D. Cal. 1996) (concluding that a reasonable investor could have been misled even though the relevant facts were disclosed in an agreement attached to an annual report where “nothing in the body of the Form 10-K discussed the marketing agreement, explained the significance of its terms, or disclosed that revenues were being recognized while Stanson had a right of return or before Stanson was actually obligated to make payment”).

53. Virginia Bankshares, Inc. v. Sandberg, 501 U.S. 1083, 1097 (1991) (“[P]ublishing accurate facts in a proxy statement can render a misleading proposition too unimportant to ground liability.”).

54. *Id.* at 1097-98 (“The point of a proxy statement, after all, should be to inform, not to challenge the reader’s critical wits. Only when the inconsistency would exhaust the misleading conclusion’s capacity to influence the reasonable shareholder would a § 14(a) action fail on the element of materiality.”).

technically sufficient to alert the investor to the truth, are so buried or hidden within the relevant document as to be practically non-disclosed.⁵⁵

Under the “buried facts” doctrine, a disclosure is deemed inadequate if it is presented in a way that conceals or obscures the information sought to be disclosed. The doctrine applies when the fact in question is hidden in a voluminous document or is disclosed in a piecemeal fashion which prevents a reasonable shareholder from realizing the “correlation and overall import of the various facts interspersed throughout” the document.⁵⁶

Furthermore, under the “bespeaks caution” doctrine, the presence of meaningful cautionary language can preclude a finding that investors were misled by projections or other forward-looking statements.⁵⁷ However, the cautionary language must “accompany” the disclosure sought to be immunized.⁵⁸ In other words, to the extent defendants are relying on one part of a document to immunize another part, proximity matters.⁵⁹ Also, the “puffery” defense precludes a finding of materiality where liability is sought to be imposed for “generalized positive statements about a company’s progress.”⁶⁰ This is based on the assumption that people expect a certain amount of salesmanship in connection with, for example, statements made by management about their business. However, like most general rules of thumb, puffery has its limits. For example, “[m]isrepresentation by implying the existence of certain facts cannot be disguised as mere

55. See *United Paperworkers*, 985 F.2d at 1199 (“[E]ven information actually sent to shareholders need not be considered part of the total mix reasonably available to them if ‘the true’ is ‘buried’ in unrelated discussions.”) (internal citation omitted).

56. *Werner v. Werner*, 267 F.3d 288, 297 (3d Cir. 2001) (quoting *Kas v. Fin. Gen. Bankshares, Inc.*, 796 F.2d 508, 516 (D.C. Cir. 1986)).

57. See *In re Donald J. Trump Casino Sec. Litig.*, 7 F.3d 357, 371 (3d Cir. 1993) (“[W]hen an offering document’s forecasts, opinions or projections are accompanied by meaningful cautionary statements, the forward-looking statements will not form the basis for a securities fraud claim if those statements did not affect the ‘total mix’ of information the document provided investors. In other words, cautionary language, if sufficient, renders the alleged omissions or misrepresentations immaterial as a matter of law.”).

58. The “bespeaks caution” doctrine was codified in § 21E of the Securities Exchange Act of 1934 as part of the Private Securities Litigation Reform Act of 1995. See 15 U.S.C.A. § 78u-5(c) (2002) (setting forth the requirement that the forward-looking statement be “accompanied by meaningful cautionary statements” in order to receive the protections of the safe harbor under one of its sub-divisions); see also 15 U.S.C.A. § 77z-2 (codifying parallel provision under the Securities Act of 1933).

59. See generally *In re Worlds of Wonder Sec. Litig.*, 35 F.3d 1407, 1414 (9th Cir. 1994) (“[T]he ‘bespeaks caution’ doctrine reflects the unremarkable proposition that statements must be analyzed in context.”).

60. *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 419 (5th Cir. 2001).

puffing.”⁶¹ Finally, the magnitude of the impact of a particular occurrence plays a role in materiality determinations even outside Simple Math cases. In the context of contingent events, whether a particular disclosure is material depends upon a balancing of the probability of the event’s occurrence and the magnitude of its impact assuming occurrence.⁶² Particularly relevant to our discussion here, magnitude may be material as an independent fact.⁶³

Courts also will often look to market reaction to assist them in making their materiality determination.⁶⁴ For example, in *Merck* the Third Circuit relied on the proposition that “the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock.”⁶⁵ While market reaction clearly is strong evidence of materiality, to equate market reaction with materiality is not without its problems. For example, there are difficulties in “isolating the reaction to the particular information as opposed to reaction to other information including broader economic, market or industry factors.”⁶⁶ Furthermore, as will be discussed in more detail below, equating *lack* of price movement with immateriality raises further

61. HAZEN, *supra* note 16, at 490 (“Similarly, use of percentages may imply a factual basis and if so, cannot be protected as mere puffing.”).

62. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 238 (1988).

63. See *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 777 (2d Cir. 1991) (“That inside directors stand to gain from a recommended transaction is material information that must be disclosed to shareholders considering a tender offer. Moreover, we may assume for purposes of our decision that there is reasonable likelihood that the magnitude of such a gain would be considered important by the reasonable investor in deciding how to act and is thus also material information.”) (internal citation omitted).

64. *But see* No. 84 Employer-Teamster Joint Council Pension Trust v. Am. W. Holding Corp., 320 F.3d 920, 934 (9th Cir. 2003) (“In *Basic*, the Supreme Court expressly adopted the ‘reasonable investor’ standard set forth in *TSC Industries* for determining materiality in the Section 10(b) and Rule 10b-5 context. . . . Pursuant to *Basic*, we reject Defendants’ argument for adoption of a bright-line rule requiring an immediate market reaction [to show materiality]. The market is subject to distortions that prevent the ideal of ‘a free and open public market’ from occurring. As recognized by the Supreme Court, these distortions may not be corrected immediately. Because of these distortions, adoption of a bright-line rule assuming that the stock price will instantly react would fail to address the realities of the market. Thus, we decline to adopt a bright-line rule, and, instead, engage in the ‘fact-specific inquiry’ set forth in *Basic*.”) (internal citations omitted).

65. *In re Merck & Co., Sec. Litig.*, 432 F.3d 261, 269 (3d Cir. 2005) (quoting *Oran v. Stafford*, 226 F.3d 275, 282 (3d Cir. 2000)).

66. 3 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD*, § 6:166 (2d ed. 2001) (“It seems to follow that actual market reaction to information after it is released is powerful evidence as to whether the information is material. However, there are some difficulties with this kind of evidence. One set includes the time period over which the reaction is to be measured (minutes, hours or days), what is to be measured (e.g., price or volume), and what measure of change indicates materiality (5%, 10%, 20%, etc). Another difficulty is isolating the reaction to the particular information as opposed to reaction to other information including broader economic, market or industry factors. Yet another is the degree to which market reaction has been diminished by the insider trading itself, which tends to move the market in the direction it will take when the information is widely known.”).

questions—particularly where that argument is made on a motion to dismiss or motion for summary judgment.⁶⁷

For all these reasons, materiality is very much a question of fact, and thus “[m]ateriality of information in a Section 10(b) and Rule 10b-5 case is ordinarily a jury question, requiring an assessment of the inferences that a reasonable shareholder would draw from a given set of facts.”⁶⁸ Thus, “a complaint may not be properly dismissed pursuant to Rule 12(b)(6) on the grounds that the alleged misstatements or omissions are not material unless they are ‘so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.’”⁶⁹

While this paper focuses on materiality, it will be impossible to avoid discussing reliance as well.⁷⁰ To begin with, courts often blur their materiality and reliance analysis, and that makes discussion of one or the other in isolation difficult. Furthermore, the issue of reliance becomes a focus of this paper in Part IV.D, where the issue of how a delayed market reaction should be analyzed in the context of the Reasonably Available Data rule is addressed. Thus, the next section will address some of the relevant issues raised by the reliance element of Rule 10b-5.

B. Reliance

To successfully state a claim for securities fraud under Rule 10b-5, plaintiffs must prove they relied on the material misstatement or omission in making their decision to buy or sell the security in question.⁷¹ There is,

67. See *U.S. v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991) (“Contending there were no material misstatements or omissions to support his § 10(b) convictions, defendant argues first that the absence of any market fluctuation in Cluett stock immediately after his 13D was filed demonstrates that the information was not important to investors. . . . Turning to defendant’s first point, whether a public company’s stock price moves up or down or stays the same after the filing of a Schedule 13D does not establish the materiality of the statements made, though stock movement is a factor the jury may consider relevant.”).

68. *Marksman Partners L.P. v. Chantal Pharm.*, 927 F. Supp. 1297, 1305-06; see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 (1988) (describing the determination of materiality as “inherently fact-specific”).

69. *Marksman Partners*, 927 F. Supp. at 1306 (quoting *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985)); see also *Provenz v. Miller*, 102 F.3d 1478, 1489 (9th Cir. 1996) (“[O]nly if materiality is so obvious that reasonable minds could not differ is summary judgment appropriate.”) (internal quotation marks and alterations omitted).

70. HAZEN, *supra* note 16, at 499 (“The reliance requirement is a corollary of materiality.”).

71. *Basic*, 485 U.S. at 243. Reliance should be reasonable. Defendants can avail themselves of the unreasonable reliance doctrine by showing that, had the plaintiff taken the time to read the relevant document carefully, the truth would have been discovered. See *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020, 1032 (2d Cir. 1993) (“An investor may not justifiably rely on a misrepresentation if, through minimal diligence, the investor should have discovered the truth.”).

however, more than one way to prove reliance in a Rule 10b-5 claim.⁷² For example, due to difficulties inherent in proving “how the plaintiff would have acted had the required information been disclosed,” many courts apply a presumption of reliance in omission cases.⁷³ However, this presumption is not universally accepted for “half truth” cases (cases where a disclosure is alleged to be misleading due to a failure to disclose a related material fact) like the ones at issue here.⁷⁴ Furthermore, where an investor trades in an efficient market, there is a presumption that he or she has relied upon the integrity of that market. In other words, “[b]ecause most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentation, therefore, may be presumed for purposes of a Rule 10b-5 action.”⁷⁵ This is called the fraud-on-the-market presumption.⁷⁶

The fraud-on-the-market presumption is rebuttable. One of the ways a defendant may rebut the presumption is to invoke the truth-on-the-market defense.⁷⁷ “Prompt incorporation of news into [the] stock price is the foundation for the fraud-on-the-market doctrine,” and this foundation “supports a truth-on-the-market doctrine as well.”⁷⁸ Under the truth-on-the-market defense, if the truth “credibly entered the market and dissipated the effects of the misstatements,” the presumption of reliance would be rebutted.⁷⁹ However, in order to gain the benefit of the truth-on-the-market defense, the defendant must show that the truth was “conveyed to the public ‘with a degree of intensity and credibility sufficient to counter-balance effectively any misleading impression created by’ the alleged misstatements.”⁸⁰ In making this showing, “defendants bear a heavy burden of proof,” and “[s]ummary judgment is proper only if they show that ‘no rational jury could find’ that the market was misled.”⁸¹

Some courts have applied the truth-on-the-market doctrine to their materiality analysis.⁸² In addition, courts are not always particularly

72. *Basic*, 485 U.S. at 243.

73. *HAZEN*, *supra* note 16, at 500.

74. See MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAW* 202 (3d ed. 2001) (“Although a number of courts have recognized this presumption in omission as well as ‘half-truth’ cases, others hold to the contrary.”).

75. *Basic*, 485 U.S. at 247.

76. See generally *HAZEN*, *supra* note 16, at 501 (“In applying the presumption of reliance and economic theory, a number of courts fashioned a fraud-on-the-market presumption for proving reliance.”).

77. See *id.* at 503 (“A number of courts have referred to a ‘truth on the market’ defense to a fraud-on-the-market theory of liability.”).

78. *Wielgos v. Commonwealth Edison Co.*, 892 F.2d 509, 516 (7th Cir. 1989).

79. *Basic*, 485 U.S. at 249.

80. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (quoting *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1994)).

81. *Provenz v. Miller*, 102 F.3d 1478, 1493 (9th Cir. 2003) (quoting *Kaplan v. Rose*, 49 F.3d 1363, 1376 (9th Cir. 1994)).

82. See *Wielgos*, 892 F.2d at 518 (“Descriptions in Forms 10-K and registration statements are

rigorous when it comes to placing the truth-on-the-market defense in their materiality or reliance analysis.⁸³ This has furthered the “creep” of the reliance defense into courts’ materiality analysis. However, there are some potential problems with turning the truth-on-the-market defense to the fraud-on-the-market presumption of reliance into a materiality defense.

First, while it seems reasonable to conclude that “[b]y its underlying rationale, the [fraud-on-the-market] presumption also shifts the critical focus of the materiality inquiry,”⁸⁴ and that “[i]n a fraud-on-the-market case the hypothetical ‘reasonable investor,’ by reference to whom materiality is gauged, must be ‘the market’ itself, because it is the market, not any single investor, that determines the price of a publicly traded security,”⁸⁵ there are some troubling conclusions to this equation. To begin with, at least in the case of widely followed companies, the conclusions of market makers⁸⁶ and sophisticated investors are likely to dominate those of the individual reasonable investor. This likelihood seems, in fact, to be the basis for another of the Supreme Court’s recognized means of rebutting the fraud-on-the-market presumption: a showing that “the ‘market makers’ were privy to the truth . . . and thus that the market price would not have been affected by the[] misrepresentations.”⁸⁷ Thus, equating the reasonable investor with the market for purposes of the materiality analysis quickly turns into equating the reasonable investor with sophisticated investors and market makers. Yet

almost useless to individual investors. They require absorption by professional traders and investors. . . . Investors who buy 500 shares of stock rely on the market price. . . . [E]verything we can see demonstrates that the market had in its possession all significant information about Commonwealth Edison.”). *But cf.* *Kapps v. Torch Offshore, Inc.*, 379 F.3d 207, 215 (5th Cir. 2004) (“[T]he court in *Wielgos* stated that it was not addressing the question of whether omitted facts were material, but was rather ruling on whether the disclosures complied with SEC rules.”).

83. *Compare Ganino*, 228 F.3d at 167 (“Because of the factual dispute over Citizens’ share price, we also reject the defendants’ attempt to rely on the so-called ‘truth on the market’ corollary to ‘fraud on the market’ as a basis for affirming the district court’s decision. Under this corollary, a misrepresentation is *immaterial* if the information is already known to the market because the misrepresentation cannot then defraud the market.”) (emphasis added), *with id.* (“A defendant may rebut the presumption that its misrepresentations have affected the market price of its stock by showing that the truth of the matter was already known.”) (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 248 (1988) (“[P]resumption of *reliance* in a fraud-on-the-market case may be rebutted by proving that ‘the ‘market makers’ were privy to the truth.’”)).

84. *Shaw v. Digital Equip. Corp.*, 82 F.3d 1194, 1218 (1st Cir. 1996), *superseded by statute on other grounds*, *Greebel v. FTP Software, Inc.*, 194 F.3d 185, 193 (1st Cir. 1999).

85. *Id.* *But cf. Basic*, 485 U.S. at 240 n.18 (“We find no authority in the statute, the legislative history, or our previous decisions for varying the standard of materiality depending on who brings the action . . .”).

86. ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS* 407 (2d ed. 1998) (“A market maker is a dealer who stands ready to buy or sell a specific stock at quoted prices . . .”).

87. *Basic*, 485 U.S. at 248.

this conclusion seemingly turns the recognized definition of materiality on its head—it is in direct conflict with the explicit “reasonable investor” standard of *TSC Industries*.⁸⁸ As discussed above, the total mix analysis already allows for defendants to avoid liability via a showing of immateriality on the basis of the truth having been available—it just views that argument from the standpoint of the reasonable investor, not the investment analyst.⁸⁹ Furthermore, equating the reasonable investor with the market for purposes of determining disclosure materiality is, at least in the registration statement context, in conflict with the SEC’s goal of regulating disclosures with an eye towards all types of investors.⁹⁰

Perhaps recognizing these problems, at least one commentator has concluded that extending the truth-on-the-market defense to materiality “portends unfortunately narrow tests of materiality.”⁹¹ In addition, a number of courts have refused to make the leap, noting that relying on “the ‘market makers’ or professional investors [as] the appropriate benchmark for determining materiality in cases that proceed under the fraud on the market theory . . . confuse[s] materiality with fraud on the market.”⁹²

[T]he reasonable investor standard is appropriate in determining materiality, and the market maker standard is only relevant when attempting to rebut the fraud on the market presumption of reliance. While there is a certain amount of redundancy in the two requirements, the Supreme Court has been quite clear

88. See *id.* at 236 (“The determination of materiality requires delicate assessments of the inferences a reasonable shareholder would draw from a given set of facts and the significance of those inferences to him.” (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976))) (internal alterations and quotation marks omitted); see also *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1308 n.6 (C.D. Cal. 1996) (“It is true that a defendant may sometimes be able to rebut the presumption of reliance in a fraud-on-the-market action under Section 10(b) and Rule 10b-5 by showing that sophisticated buyers, or ‘market makers,’ were not taken in by the misrepresentations at issue. . . . [However], the ‘market maker’ perspective has no bearing on the question of materiality, which is based instead on the perspective of a ‘reasonable investor.’”).

89. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1097 (1991) (“[N]ot every mixture with the true will neutralize the deceptive. If it would take a financial analyst to spot the tension between the one and the other, whatever is misleading will remain materially so, and liability should follow.”).

90. See Kenneth B. Firtel, Note, *Plain English: A Reappraisal of the Intended Audience of Disclosure Under the Securities Act of 1933*, 72 SO. CAL. L. REV. 851, 851 (1999) (“Over the years, bitter debate has surrounded the issue of for whom securities disclosure is intended. The Securities and Exchange Commission (“SEC”) has maintained that disclosure should be geared toward all types of investors, from the average investor to the professional financial analyst.”); see also *Cox Links Corporate Profits To ‘Plain English’ Disclosures*, 38 SEC. REG. & L. REP. 1160 (July 3, 2006) (discussing proposal to extend successful plain English focus to executive compensation disclosures, particularly so as to provide “clearer answers to the question ‘how much’”).

91. HAZEN, *supra* note 16, at 134.

92. *Cione v. Gorr*, 843 F. Supp. 1199, 1202 (N.D. Ohio 1994).

and consistent in its use of the reasonable investor standard in the materiality context.⁹³

The significance of all this is that if courts consistently allow defendants to import the truth-on-the-market defense into their materiality analysis in fraud-on-the-market cases, then a resulting “watering-down” of what constitutes material information under the case law may occur and overall disclosure may suffer.⁹⁴ This is possible because (1) “the vast body of case law under [Rule 10b-5] is a type of de facto federal common law of securities fraud,” and (2) “the hallmark of disclosure for both the 1933 Act registration statement and all 1934 Act filings is embodied in the concept of ‘materiality.’”⁹⁵ Given that defendants should be able to adequately defend themselves against liability by focusing their truth-on-the-market defense on the element of reliance, the risk to full and fair disclosure arguably presented by allowing the doctrine to serve as a materiality defense seems unnecessary.⁹⁶ Either way, “[t]he truth-on-the-market defense is intensely fact-specific and is rarely an appropriate basis for dismissing a § 10(b) complaint for failure to plead materiality.”⁹⁷ Of course, defendants can successfully reassert the defense at a later stage in the litigation.⁹⁸

93. *Id.*; see also *Robinson v. Penn Cent. Co.*, 336 F. Supp. 655, 657 (E.D. Pa. 1971) (“It may be that a sophisticated analyst, with knowledge of the corporate world, would ultimately deduce from the proxy material [the material information]. However, our concern is not the sophisticated analyst, but the reasonable stockholder . . .”).

94. *Cf.* Andrea M. Matwyshyn, *Material Vulnerabilities: Data Privacy, Corporate Information Security, and Securities Regulation*, 3 BERKELEY BUS. L.J. 129, 186 n.218 (2005) (“As part of 10K annual reports, public entities are required to disclose all ‘material’ events in the life of the business that may impact a shareholder’s investment in the entity. The definition of materiality, however, is in flux and much discretion regarding whether an event is ‘material’ for disclosure purposes remains with the company engaging in the disclosures.”).

95. HAZEN, *supra* note 16, at 3, 119. For example, Reg. S-K, Item 303, which provides instructions for the “Management’s Discussion and Analysis” section of an issuer’s registration statement, references the concept of materiality in guiding disclosure on liquidity, capital resources, results of operations and off-balance sheet arrangements. See 17 C.F.R. § 229.303 (2004); see also 17 C.F.R. § 240.12b-20 (2004) (“In addition to the information expressly required to be included in a statement or report, there shall be added such further *material* information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made not misleading.”) (emphasis added).

96. *Cf.* *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 415 (5th Cir. 2001) (“While we agree with *Burlington [Coat Factory Sec. Litig.]*, 114 F.3d 1410 (3d Cir. 1997) and the district court as to the requirement, in cases depending on the fraud-on-the-market theory, that the complained of misrepresentation or omission have actually affected the market price of the stock, we conclude that it is more appropriate in such cases to relate this requirement to reliance rather than to materiality. That is how both *Basic, [Inc. v. Levinson]*, 485 U.S. 224 (1987) and *Abell [v. Potomac Ins. Co.]*, 858 F.2d 1104 (5th Cir.1988), *vacated on other grounds sub. nom. Fryar v. Abell*, 492 U.S. 914 (1989) approach the matter.”).

97. *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 167 (2d Cir. 2000) (citing *Provenz v. Miller*, 102

Before moving on to a discussion of the specific problem and proposed solution addressed by this paper, a few comments regarding scienter and the heightened pleading standards under the Private Securities Litigation Reform Act are appropriate.

C. *Scienter, Loss Causation & Heightened Pleading Standards*

In order to prevail on a Rule 10b-5 claim, plaintiffs must prove that the defendants acted with scienter.⁹⁹ In satisfying this element, “the vast majority of the circuit and district court decisions have found that recklessness is sufficient” to make the requisite showing.¹⁰⁰ Furthermore, under the Private Securities Litigation Reform Act (“PSLRA”), a Rule 10b-5 claim must “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.”¹⁰¹ Whether pleading facts showing motive and opportunity is sufficient is an open question.¹⁰² Regardless, plaintiffs in *Merck* would certainly have a difficult time carrying their burden on this element even if the omission of the bottom line in that case was found to be material under the Reasonably Available

F.3d 1478, 1493 (1996)) (noting that summary judgment based on the “truth on the market” doctrine is appropriate only if defendants show that “no rational jury could find that the market was misled”) (internal quotation marks omitted)); *see also id.* at 168 (“[E]ven assuming that HTCC’s disclosures were factually accurate, we cannot decide on the present record whether those disclosures were conveyed with sufficient ‘intensity and credibility’ as to dispel the false impression created by Citizens’ alleged misrepresentations. Therefore, we decline to affirm the district court’s opinion based on the ‘truth on the market’ doctrine.”).

98. *See In re Newbridge Networks Sec Litig.*, 962 F. Supp. 166, 178 n.2 (D.D.C. 1997).

99. HAZEN, *supra* note 16, at 370. *But see id.* (“However, scienter is not required to establish a violation of Rule 14a-9’s prohibitions against material misstatements and omissions in connection with a proxy solicitation.”). To the extent I argue that the presence of a scienter element in Rule 10b-5 claims should mitigate concerns about the possible plaintiff-friendly effects of the Reasonably Available Data rule, the lack of a scienter element in cases arising under Rule 14a-9 raises some interesting questions. While a thorough analysis of these questions is beyond the scope of this article, it is worth noting that any heightened burden placed on defendants as a result of the interplay of the Reasonably Available Data rule and the lack of a scienter requirement under Rule 14a-9 may be justified by the fact that in the proxy solicitation context management is expressly reaching out to shareholders and requesting them to take action—warranting some lessened “wiggle room” in terms of disclosure. The issue also arises as to §§ 12(a)(2) and 17(a) of the ‘33 Act and § 14(e) of the ‘34 Act. *See generally id.* at 303, 430.

100. *Id.* at 483.

101. 15 U.S.C. § 78u-4(b)(2) (2000). The PSLRA also requires more generally that “the complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed.” *Id.* at 74-u(b)(1). This requirement codifies the requirement under Rule 9(b) of the Federal Rules of Civil Procedure that fraud be pleaded “with particularity.” *See generally* HAZEN, *supra* note 16, at 511.

102. *See Fla. State Bd. of Admin. v. Green Tree Fin’l Corp.*, 270 F.3d 645, 658 (8th Cir. 2001) (noting circuit split).

Data rule.¹⁰³ This is an important point to the extent some may argue that the Reasonably Available Data rule is too plaintiff-friendly.

Plaintiffs pursuing a Rule 10b-5 claim must also prove that the fraud was the proximate cause of their loss.¹⁰⁴ While loss causation can be a highly factual issue, the enhanced pleading requirements for securities fraud allow for dismissal where a complaint fails “to specifically allege facts showing loss causation.”¹⁰⁵ Again, this heightened pleading requirement serves to mitigate any perceived excessive shift in favor of plaintiffs under the proposed Reasonably Available Data rule. We turn now to examine that proposed rule, and the problem it is offered to solve.

III. OVERVIEW OF THE PROBLEM AND PROPOSED SOLUTION

A. The Problem

“The courts have generally agreed that readers can put two and two together, and make somewhat more elaborate calculations or comparisons.”¹⁰⁶ On its face, this does not appear to be a particularly troubling practice. However, even a good rule of thumb can create problems when it is indiscriminately applied. For example, the Third Circuit in *Merck* acknowledged that Merck “should have disclosed the amount of co-payments recognized as revenue”¹⁰⁷ However, despite this normative conclusion, the court in effect relied on the Simple Math rule to grant Merck’s motion to dismiss—even though Merck not only failed to disclose the bottom line but also all the necessary data to calculate it.¹⁰⁸ Another case, *Werner v. Werner*,¹⁰⁹ also from the Third Circuit, held that failure to disclose the magnitude of the gain flowing to interested directors in connection with a transaction they were recommending to shareholders was immaterial because shareholders could calculate that magnitude by: (1)

103. See *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 268 (3d Cir. 2005) (“The District Court discussed briefly the issue of materiality regarding Union’s § 10(b) claim, but it did not reach the issue because it ultimately found that Union had failed sufficiently to show scienter.”); see also *id.* at 271 n.9 (“Scienter and reliance typically would come next in our analysis after materiality. But because we have decided that the initial S-1 disclosure was not materially false or misleading and did not omit sufficient facts, we do not discuss scienter here.”) (internal citation omitted).

104. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 338 (2005) (citing 15 U.S.C. § 78u-4(b)(4)).

105. *HAZEN*, *supra* note 16, at 507.

106. 2 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD & COMMODITIES FRAUD*, § 5:237 (2d ed. 2001) [hereinafter 2 BROMBERG & LOWENFELS].

107. *Merck*, 432 F.3d at 271.

108. See *id.*

109. 267 F.3d 288 (3d Cir. 2001).

recognizing that a planned removal of a right of first refusal under an equity incentive plan, as set forth in the relevant 1997 proxy statement, would benefit management;¹¹⁰ (2) then looking “to the 1993 and 1994 annual reports to determine how many shares were issued each year pursuant to the Restricted Stock Plan”;¹¹¹ (3) then using those same reports to “determine the approximate fair market value (‘FMV’) of Restricted shares at the date of issuance”;¹¹² (4) then employing the equation “[(FMV 1997 – FMV in 1993) x number of shares issued in 1993] + [(FMV 1997 – FMV 1994) x number of shares issued in 1994]” in order to “compute the amount of money the management defendants would have gotten for their shares had the right of first refusal been exercised”;¹¹³ and then finally, (5) comparing “the amount yielded by the above equation to the \$66 million the management defendants would actually receive in the Recapitalization as proposed.”¹¹⁴ At least some would agree that this labyrinth-like disclosure of a material fact¹¹⁵ is not consistent with a philosophy of full and fair disclosure.¹¹⁶ These and other examples of application of the Simple Math rule that seemingly permit less than full and fair disclosure are examined further below.

110. *Id.* at 299.

111. *Id.* at 299-300.

112. *Id.* at 300.

113. *Id.*

114. *Id.*

115. See *Kramer v. Time Warner, Inc.*, 937 F.2d 767, 777 (2d Cir. 1991) (“That inside directors stand to gain from a recommended transaction is material information that must be disclosed to shareholders considering a tender offer. Moreover, we may assume for purposes of our decision that there is reasonable likelihood that the magnitude of such a gain would be considered important by the reasonable investor in deciding how to act and is thus also material information.” (internal citation omitted) (citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976); *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988))).

116. See *Kennedy v. Tallant*, 710 F.2d 711, 720 (11th Cir. 1983) (“The district judge found that any relevant disclosures with regard to control were so fragmented throughout the prospectuses that the average person would not understand their import. We agree. Full and fair disclosure cannot be achieved through piecemeal release of subsidiary facts which if stated together might provide a sufficient statement of the ultimate fact.”); Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883, 921-22 (2000) (“[I]t appears that *Kennedy* holds actionable the failure to summarize information, or provide a conclusion that appears self-evident, based on the fact that the information in question was spread out over a few pages. If the knowledge and effort required to assimilate that information is sufficiently substantial to make disclosure misleading, it follows a fortiori that the general availability of information in the market does not necessarily eliminate the materiality of its omission. The SEC’s recent requirement that prospectuses be drafted in ‘plain English’ similarly indicates the importance of the manner in which disclosure is made.”).

B. The Proposed Solution

There is a tension in the law of securities regulation, between the desire to protect investors via full and fair disclosure,¹¹⁷ and the desire to avoid the negative consequences of excessive litigation and overly burdensome disclosure requirements.¹¹⁸ This tension is first addressed in the particular statutes and regulations that make up the Securities Act and the Exchange Act. In addition, various common law “safety valves” have sprung up in order to allow courts to manage securities cases in light of various market and litigation realities. On the one hand, there exists the reality that securities fraud cases are routinely decided on the motions. Because of the great cost associated with litigating these claims, if corporations do not prevail on their motions to dismiss or motions for summary judgment, they will generally have to settle the case.¹¹⁹ Thus, courts have employed doctrines such as “bespeaks caution”¹²⁰ and “puffery”¹²¹ to allow them to decide cases on the motions where otherwise there would be questions of fact (particularly as to materiality) remaining. The rule-of-thumb that I am calling the Simple Math rule—which states that requiring investors to perform mathematical calculations to determine the bottom line does not constitute fraud as a matter of law—can be seen as one of these safety valves, designed to relieve some of the excessive litigation pressure created by frivolous lawsuits. However, in its application the rule seemingly differs from other safety valves in that it does not require the courts to perform any balancing of the particular facts.

In this paper, I am proposing an alternative to the Simple Math rule—the Reasonably Available Data rule. The Reasonably Available Data rule would continue to recognize that investors “can put two and two together,

117. See, e.g., Pub. L. No. 107-204 (2002) (“An Act To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws . . .”).

118. See, e.g., Pub. L. No. 104-67 (1995) (“An Act to reform Federal securities litigation . . .”).

119. I propose the Reasonably Available Data rule as generally applicable. In this paper, however, I will focus on its relevance in the context of dismissal and summary judgment motions. This focus is important because it is at these stages of litigation that courts set precedent for what is material as a matter of law.

120. See *In re Donald J. Trump Casino*, 7 F.3d 357, 364 (3d Cir. 1993) (“The linchpin of the district court’s decision was what has been described as the ‘bespeaks caution’ doctrine, according to which a court may determine that the inclusion of sufficient cautionary statements in a prospectus renders misrepresentations and omissions contained therein nonactionable.”).

121. See *Nathenson v. Zonagen, Inc.*, 267 F.3d 400, 417 n.15 (5th Cir. 2001) (“[T]he statements were at most mere optimistic generalizations consisting of ‘the type of ‘puffing’ that . . . [the] circuits have consistently held to be inactionable” (quoting *Lasker v. New York State Elec. & Gas Corp.*, 85 F.3d 55, 59 (2d Cir. 1996))).

and make somewhat more elaborate calculations or comparisons.”¹²² However, it would require courts to apply more analytical rigor in situations where strict application of the Simple Math rule would risk the underinclusiveness feared by the Supreme Court where bright line rules are applied in connection with materiality determinations.¹²³ Where a defendant argues that failure to disclose the bottom line was immaterial because the data necessary to calculate it was disclosed, courts should approach their analysis in a manner similar to other cases where a defendant points to separate disclosures to prove a challenged representation or omission immaterial. In accord with the relevant materiality factors discussed above, courts should not simply ask whether the necessary data was disclosed.¹²⁴ Rather, borrowing from the “bespeaks caution” doctrine, they should first ask whether all the relevant pieces of data necessary to calculate the bottom line were disclosed proximately to one another and the place where a reasonable investor would expect to find them.¹²⁵ If so, the court can stop its analysis and properly apply the Simple Math rule.¹²⁶ If the data is not sufficiently proximate, then, in accord with a “total mix” analysis, they should ask whether that data was reasonably available, specifically checking to see if it was cross-referenced to. If the court concludes the data was not reasonably available, the motion to dismiss should be denied. If the data was reasonably available, then the question becomes—in accord with the hidden facts doctrine—whether the import of the data was sufficiently highlighted to alert the reasonable investor.¹²⁷ Again, if the import of the data was not sufficiently highlighted, the court should deny the motion to

122. 2 BROMBERG & LOWENFELS, *supra* note 106, at § 5:237.

123. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 236 n.14 (1988); see also *id.* at 236 (“After much study, the Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula. Courts also would do well to heed this advice.” (internal footnote omitted)).

124. I do not argue that factors such as proximity and the presence of cross-referencing should be relevant under the Reasonably Available Data rule because they are factors under other materiality doctrines. Rather, I believe the various factors I propose are appropriate on their own merit. The fact that they are employed in the application of other materiality doctrines supports, rather than mandates, this conclusion.

125. See *Mills v. Elec. Autolite Co.*, 403 F.2d 429, 434 n.5 (1968) (“The language used and the position and emphasis given to each statement[] may be considered in determining whether there has been a fair and candid disclosure of a material fact.” (quoting *Richland v. Crandall*, 262 F. Supp. 538, 554 (S.D.N.Y. 1967))) (internal alterations omitted), *vacated on other grounds*, 396 U.S. 375 (1970).

126. One possible exception may be where the equation necessary to calculate the bottom line is so complicated as to make calculation unreasonable. In such a case, dismissal may be improper even where all the data is proximately disclosed.

127. See *Kohn v. Am. Metal Climax, Inc.*, 322 F. Supp. 1331, 1362 (E.D. Pa. 1971) (“The Securities Exchange Act requires more than disclosure, it requires adequate disclosure. The more material the facts, the more they should be brought to the attention of the public. To view it otherwise would be to invite frustration of the policies underlying our disclosure laws. Accordingly, we have found certain facts to be ‘buried’ in the explanatory materials. These facts should have in some way been highlighted to insure that the shareholders were aware of them.”).

dismiss.¹²⁸ Furthermore, failure to disclose the bottom line in connection with a *corrective* disclosure should constitute an additional factor weighing against defendants. As will be discussed more below, it is reasonable to assume that the risk of misleading investors by failing to disclose the bottom line is even greater with a corrective disclosure. And finally, where the market reacts negatively to a subsequent disclosure of the bottom line, a presumption of materiality should be applied.¹²⁹

From a policy standpoint, the Reasonably Available Data rule makes sense. One may presume that the Simple Math rule advances the policy objective of allowing courts to dismiss frivolous suits that would otherwise continue to trial. This is so because the materiality of failure to disclose the bottom line would ordinarily present a question of fact not appropriately decided as a matter of law. By providing courts with a safety valve uniquely applicable to such cases, the Simple Math rule serves a purpose most would agree is desirable. However, as will be demonstrated below, application of the Simple Math rule casts too wide a net. It results in the dismissal of claims that seemingly can only appear frivolous to supporters of corporate protectionism. The Reasonably Available Data rule, on the other hand, also serves a safety valve function, but in the context of an analytical scheme less likely to dismiss legitimate claims. This is particularly important in light of the fact that, as discussed above, judicial materiality determinations influence securities regulation far beyond the four corners of a particular opinion. Furthermore, strict adherence to the Simple Math rule creates

128. See *id.* at 1363 (“[T]he stockholders are only referred generally to Appendix Q. . . . This does not sufficiently highlight [the material] fact.”). Cf. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 753 (1975) (“The SEC, in accord with the congressional purposes, specifically requires prominent emphasis be given in filed registration statements and prospectuses to material adverse contingencies.”).

129. One (perhaps) obvious question is why we need a new rule at all. Can’t we just apply existing materiality doctrines more effectively? I believe there are two answers to this question. First, results will be too inconsistent without adopting a rule specifically applicable in cases where defendants have only disclosed the data necessary to calculate the bottom line. There is nothing preventing courts from applying the existing doctrine currently (and, indeed, some do—see, e.g., *Robinson v. Penn Cent. Co.*, 336 F. Supp. 655, 657 (E.D. Pa. 1971) (applying buried facts doctrine to find violation of ‘34 Act even though it was possible to “deduce from the proxy material” that “the debt would have grown from \$50,000,000 to \$80,000,000”)), yet we are still left with the problematic cases cited in this article. Second, it is my contention that none of the existing materiality doctrines fully addresses the concerns raised by Simple Math cases. The decision-tree analysis proposed here constitutes an improvement over the existing doctrine by providing more flexibility than the Simple Math rule, while still providing the necessary guidance to corporations in formulating their disclosures. See, e.g., *Werner v. Werner*, 267 F.3d 288, 298 (3d Cir. 2001) (finding adequate disclosure despite the necessity of a five to six-step equation to calculate the bottom line because “the Restricted Stock Plan was prominently addressed in a contiguous section of the letter accompanying the 1991 annual report, as well as in the report itself and in subsequent annual reports”).

incentives for corporations to provide less information and expect shareholders to engage in greater extrapolation—a result at odds with the undergirding securities regulation philosophy of full and fair disclosure.¹³⁰ Conversely, the Reasonably Available Data rule will encourage corporations to think not only about whether they are disclosing all necessary numbers, but whether the impact of combining those numbers in some meaningful way is material. The corporate scandals of recent memory suggest courts should tread cautiously in rendering rulings that encourage corporations to “hide the ball” from investors.

IV. APPLICATION OF THE PROPOSED SOLUTION TO RELEVANT CASE LAW

The relevant cases can be broken up into four groups. The first group is made up of those cases where all the pieces of information necessary to calculate the bottom line are disclosed proximately to one another and to the statement alleged to have been made materially misleading by the omission of the bottom line, or to the place where disclosure of the bottom line would have reasonably been expected. I argue that this is the group of cases where the Simple Math rule works well. The data is clearly reasonably available to the investor and no cross-references are required.

In the second group of cases, all the pieces of data necessary to calculate the bottom line are not disclosed proximately to one another or to the statement alleged to have been made materially misleading by the omission of the bottom line or the place where disclosure would be expected.¹³¹ Here, I argue courts act too quickly when they dismiss claims simply by invoking the Simple Math rule. Rather, courts should ask whether the data was disclosed in such a manner—looking to the factors set forth above—to warrant ignoring the general rule that “[m]ateriality of information in a [] Rule 10b-5 case is ordinarily a jury question, requiring an assessment of the inferences that a reasonable shareholder would draw from a given set of facts.”¹³²

The third group of cases are those in which the omission occurred in connection with a corrective disclosure.¹³³ I argue that where a corporation

130. See generally *In re Merck & Co. Sec. Litig.*, 432 F.3d 261 (3d Cir. 2005) (finding that the corporation’s non-disclosure of subsidiary’s revenue-recognition practices was not a material omission).

131. A good argument can be made that this group should be divided further into cases where the necessary data was completely disclosed and cases, like *Merck*, where anyone desiring to calculate the bottom line was required to make an assumption or fill in some missing piece of data. The latter group of cases would raise the issue of when leaving a blank in the necessary calculation equates to non-disclosure of the necessary data.

132. *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1305-06 (C.D. Cal. 1996).

133. Note that there may be overlap of groups. When that occurs, the argument against ruling in favor of defendants on motions to dismiss or summary judgment is even greater.

is making a corrective disclosure, it is reasonable for investors to expect disclosure of the bottom line impact if it is significant. Where this is not done, the message is, in effect: "We admit we did something wrong, but it was merely a technical violation—no real harm resulted." Thus, where the bottom line is omitted in connection with a corrective disclosure, courts should count that fact against defendants.

Finally, the fourth group of cases are those in which the market reacts negatively after the bottom line is publicly disclosed. Courts may brush aside plaintiffs' arguments that the market took time to digest material information by concluding that such an argument destroys the basis (where applicable) for plaintiffs' fraud-on-the-market presumptive reliance. This is one of the arguments relied on by the Third Circuit in *Merck*: "[Plaintiff] is trying to have it both ways: the market understood all the good things that Merck said about its revenue but was not smart enough to understand the [revenue] disclosure."¹³⁴ I argue, however, that because the very crux of these cases is that the bottom line was *not* disclosed, the failure of the market to "do the math" immediately should not deprive plaintiffs of the fraud-on-the-market presumption in light of the policy reasons in favor of the presumption.

A. The "Proximately Disclosed" Cases

In *Starr v. Georgeson Shareholder, Inc.*, the Second Circuit held that an exchange agent's failure to disclose the total fee charged for providing its service was immaterial as a matter of law where the agent properly disclosed the fee per share.¹³⁵ In that case, Georgeson Shareholder, Inc. ("Georgeson"), had been brought in to facilitate a post-merger "clean up" of shares to be converted in two separate mergers—one in which Vodafone Group, Plc ("Vodafone"), was the surviving entity, and one in which AT&T Corporation ("AT&T") was the surviving entity.¹³⁶ Plaintiff tendered shares to Georgeson in connection with both mergers, and filed suit after Georgeson allegedly deducted roughly nine percent of the tendered stock's value in connection with the Vodafone merger, and roughly twelve percent in connection with the AT&T merger.¹³⁷ However, Georgeson had expressly disclosed the \$3.50 (per Vodafone share) and \$7 (per AT&T

134. *Merck*, 432 F.3d at 270.

135. 412 F.3d 103, 111 (2d Cir. 2005).

136. *Id.* at 105 ("Georgeson was retained to 'clean up' the mergers by locating and soliciting missing or reluctant shareholders to convert their pre-merger stock into shares of the post-merger companies.").

137. *Id.* at 107-08.

share) processing fees in the body of the notices sent soliciting tender of the shares.¹³⁸ The Second Circuit concluded that:

Simply multiplying these fees by the number of stock certificates held would have provided a shareholder with the fee Georgeson charged to exchange shares. We agree [with the District Court] that “[r]equiring [a] stockholder to perform the two-minute multiplication to ascertain the fee is not an ‘omission’ for which the law gives redress.”¹³⁹

Similarly, in *Gavin v. AT&T Corp.*,¹⁴⁰ the District Court for the Northern District of Illinois, in addressing a similar claim against Georgeson brought by a different plaintiff, found the omission of the total fee to be immaterial as a matter of law:

The notice clearly stated that the fee would be \$7 for each share of AT&T to be received, and the claim card attached to the notice indicated the number of those shares. Georgeson’s failure to perform the one-step multiplication required to ascertain the total fee is not an omission for which the securities laws provide redress. The securities laws are intended to require fair disclosure, but do not require corporations to “attribute to investors a child-like simplicity” This claim fails.¹⁴¹

These results are consistent with the Reasonably Available Data rule proposed here. All the data necessary to perform the calculation was disclosed together and where a reasonable investor would have expected it to be. In such a case, courts are justified in relying on the Simple Math rule to dismiss cases claiming a violation of the securities laws based upon a failure

138. *Id.* at 106, 108.

139. *Id.* at 111 (quoting *Starr v. Georgeson S’holder, Inc.*, 287 F. Supp. 2d 410, 414 (S.D.N.Y. 2003)).

140. No. 01 C 2721, 2005 WL 1563122 (N.D. Ill. June 7, 2005).

141. *Id.* at *12 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 234 (1988)) (internal citations omitted). While I agree with the result, it is interesting to note that the *Gavin* court relied on the Supreme Court’s admonition not to attribute a child-like simplicity to investors in order to support the non-disclosure of information. In making this statement, the Supreme Court was in fact urging disclosure, rebutting the argument that investors would be unable to understand the uncertainty inherent in premerger negotiations:

Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress. . . . The role of the materiality requirement is not to attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations, but to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger mix of factors to consider in making his investment decision.

Basic, 485 U.S. at 234 (internal quotation marks and citations omitted).

to disclose the bottom line—and application of the Reasonably Available Data rule would obtain the same result.

B. The “Dispersed Data” Cases

The first dispersed data case we shall turn to is the *Merck* case cited in the Introduction. In that case, Merck was planning to spin off its wholly-owned subsidiary, Medco, in a 2002 IPO.¹⁴² Medco, as a pharmacy benefits manager (“PBM”), “saves its clients (plan sponsors) money by negotiating discount rates with pharmacies and influencing doctors to prescribe cheaper, but still therapeutically appropriate, medicines.”¹⁴³ When a plan beneficiary buys drugs at a pharmacy, Medco confirms the beneficiary’s plan enrollment.¹⁴⁴ The beneficiary is then charged only a co-payment for the drug—usually less than \$15.¹⁴⁵ The co-payment belongs to the pharmacy.¹⁴⁶ Medco, however, recognized these co-payments as its own revenue.¹⁴⁷ Furthermore, Merck, in its 1999 10-K, “stated that Medco recognized revenue ‘for the amount billed to the plan sponsor.’”¹⁴⁸ In connection with an auditor change, Merck changed its disclosure in its 2001 10-K to read “that revenues were ‘recognized based on the prescription drug price negotiated with the plan sponsor.’”¹⁴⁹

142. *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 264 (3d Cir. 2005).

143. *Id.*; see also Barbara Martinez, *Selling Generic Drugs by Mail Turns Into Lucrative Business*, WALL ST. J., May 9, 2006, at A1 (“For a while, a good chunk of the PBMs’ profits came from incentives provided by drug makers. PBMs would try to badger doctors into switching prescriptions to a particular brand. The PBMs could reap lucrative rebates from drug makers for doing this. After an outcry about the practice a few years ago, PBMs started sharing more of the rebates with employers.”); Martinez, *supra*, at A1 (“In many industries, middlemen scrape by on small margins. Not so in generic drugs. Documents from 2001 filed in an Ohio court case show that Medco Health Solutions Inc. paid \$90 that year for the pills to fill 114 prescriptions for a generic copy of Valium. Medco sent its client, the State Teachers Retirement System of Ohio, a bill of \$1,028 for the drugs, which also reflected its dispensing costs. Medco paid \$766 for the pills to fill hundreds of prescriptions for the blood-pressure medicine atenolol. It billed the Ohio teachers \$25,628.”).

144. *Merck*, 432 F.3d at 264.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*; see also Barbara Martinez, *Merck to Proceed With the IPO of 20% of Medco Benefits Units*, WALL ST. J., July 9, 2002, at A6 (“A Merck spokeswoman said: ‘In 1999 we had discussions with the SEC about Medco revenue-recognition practices. We expanded our public disclosure in this area and the SEC raised no further questions.’”).

149. *Merck*, 432 F.3d at 264. It should be noted that Medco believed it could properly recognize the co-payments as revenue under the applicable accounting standards, *id.*, and “Merck apparently subtracted out these co-payments later, so its profit numbers were unaffected by this policy.” *Id.* at 264 n.2.

On April 17, 2002, in Merck's initial S-1 filing in connection with the planned Medco offering, Merck for the first time disclosed that Medco had recognized the co-payments as revenue.¹⁵⁰ The disclosure consisted of a "brief mention of Medco's revenue-recognition policy" in the "200-page" filing.¹⁵¹ More importantly for our purposes, Merck did not disclose the total amount of additional revenue recognized.¹⁵² The market's response to this disclosure was a resounding yawn.¹⁵³

However, on June 21, 2002, an article in *The Wall Street Journal* reported on Medco's practice of recognizing co-payments as revenue, and estimated that those co-payments totaled \$4.6 billion in 2001.¹⁵⁴ This time, the market shuddered—Merck's stock dropped from \$52.20 to \$49.98 that same day.¹⁵⁵ Six days later, Merck postponed "the Medco IPO and indicated it would drop the Medco offering price."¹⁵⁶ On July 5, 2002, Merck filed its fourth S-1, finally disclosing the full amount of co-payments recognized as revenue.¹⁵⁷ In that disclosure, it revealed that the actual amount of co-payments never received but recognized as revenue by Medco was \$5.54 billion¹⁵⁸—almost \$1 billion more than had originally been calculated by *The Wall Street Journal* reporter based on an assumption due to the disclosure's incompleteness.¹⁵⁹ The following business day, Merck shares slipped another \$1.05, or 2.2%.¹⁶⁰ Overall, Medco had recognized in excess of \$12.4 billion dollars in co-payment revenue over the course of 3 years: \$5.537 billion in 2001; \$4.036 billion in 2000; and \$2.838 billion in 1999.¹⁶¹ By July 10, the day after the close of the class period,¹⁶² Merck's stock had dropped to \$43.57,¹⁶³ for a total decline of about 17% from the date of *The Wall Street Journal* article.

150. *Id.* at 264.

151. Martinez, *supra* note 148, at A6.

152. *Merck*, 432 F.3d at 264.

153. *Id.* ("The day this S-1 was filed, Merck's stock price went up \$0.03—from \$55.02 to \$55.05.").

154. *Id.* at 265 (citing Barbara Martinez, *Merck Included Co-Payments Among Revenue*, WALL ST. J., June 21, 2002, at C1).

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.*

159. See Martinez, *supra* note 148, at A6.

160. *Id.* ("A brief mention of Medco's revenue-recognition policy first appeared in a 200-page Securities and Exchange Commission filing in April. It wasn't until this past Friday, however, that Merck detailed that between 1999 and 2001, retail co-payments represented \$12.4 billion, or nearly 10%, of Merck's overall reported revenue. . . . [the following Monday] Merck shares slipped \$1.05, or 2.2% . . . to \$47.81 in 4 p.m. composite trading on the New York Stock Exchange.").

161. *Merck*, 432 F.3d at 265.

162. *Id.* at 264 n.1 ("The class period runs from January 26, 2000, to July 9, 2002.").

163. *Id.* at 265.

The Third Circuit focused its materiality analysis on the disclosure by Merck, in its April 17th S-1, of the fact that Medco had recognized co-payments never received as revenue.¹⁶⁴ Touting its “clearest commitment” to the efficient market hypothesis,” and stating that “the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm’s stock,” the Court concluded that Medco’s recognizing co-payment revenue was immaterial as a matter of law because the price of Merck’s stock did not decline after disclosure of the practice.¹⁶⁵ As for the argument that, by failing to disclose the magnitude of co-payment revenue recognized, “the April 17th disclosure was so opaque that it should not have counted as a disclosure[.]” the Court held that since all the necessary information to calculate the amount of excess revenue recognition was available when the April 17th disclosure was made, failure to do the calculation for investors was immaterial.¹⁶⁶

Was this the correct result? The court acknowledged that “Merck was clearly treading a fine line with this delayed, piecemeal disclosure[.]” and “decline[d] to decide how many mathematical calculations [were] too many” because it did “not wish to reward opaqueness.”¹⁶⁷ Nevertheless, the court granted Merck’s motion to dismiss, minimizing the stock price’s drop in response to the *Wall Street Journal* (“*Journal*”) article by stating that “[t]he *Journal* reporter simply did the math on June 21.”¹⁶⁸ This fact, however, simply begs the questions posed here: Who *should* do the math? And, when can a defendant rely on an assumption that the market will do it? Ironically, the Third Circuit seemingly contradicted itself when it answered these questions by stating that Merck “should have disclosed the amount of co-payments recognized as revenue in the April S-1.”¹⁶⁹

The Reasonably Available Data rule would likely not have allowed Merck to prevail on its motion to dismiss on the basis of the Simple Math rule because the necessary data was not all disclosed where the reasonable

164. *Id.* at 269.

165. *Id.* (quoting *Oran v. Stafford*, 226 F.3d 275, 282 (3d. Cir. 2000)). Apparently, however, the Third Circuit’s commitment to the efficient market hypothesis is not without its limits. See *Oran*, 226 F.3d at 285 n.5 (considering it “more reasonable” that a four percent drop in the share price of a pharmaceutical company was due to a “delayed investor reaction” to a two-day-old drug withdrawal announcement rather than the same-day disclosure—in the *New York Times* and *Wall Street Journal*—of the company’s prior knowledge of one of its drug’s possible connection to heart-valve abnormalities).

166. *Merck*, 432 F.3d at 270.

167. *Id.* at 271.

168. *Id.*

169. *Id.*

investor would expect to find it (in fact, part of the necessary data was not disclosed at all), and there remained too many questions about whether the “piecemeal disclosure”¹⁷⁰ was made in such a way as to offset the arguably misleading impression created by Merck’s failure to disclose it. A good argument can be made that this alone should have been sufficient to allow the plaintiff to avoid dismissal. However, as will be discussed further below, *Merck* also involved a corrective disclosure and a price drop in connection with public disclosure of the bottom line.¹⁷¹ These are additional factors weighing against dismissal under the Reasonably Available Data rule.

The Reasonably Available Data rule recognizes that it is appropriate to dismiss securities claims based on a failure to disclose the bottom line where all the pieces of data necessary to calculate that bottom line were disclosed proximately to one another. In *Merck*, the *Journal* reporter needed to make an assumption regarding the average co-payment in order to calculate the bottom line.¹⁷² In fact, it was because her assumption was incorrect, that the co-payment revenue she reported was actually low.¹⁷³ But this was not just a case of Merck’s failing to provide a necessary piece of data. According to the *Journal* article, Merck affirmatively refused to disclose its average co-payment.¹⁷⁴

Given that this was not a case where all the necessary data was proximately disclosed, the question under the Reasonably Available Data rule would become whether the data was nonetheless disclosed in such a manner as to warrant a court’s allowing it to serve as a proxy for explicit disclosure of the bottom line.¹⁷⁵ In *Merck*’s case, this seems to be an open

170. *Id.*

171. *Id.* at 264-65.

172. *Id.* at 270 (“The *Journal* reporter arrived at an estimate of \$4.6 billion of co-payments recognized in 2001 by using one assumption and performing one subtraction and one multiplication on the information contained in the April S-1. She determined the number of retail prescriptions filled (462 million) by subtracting home-delivery prescriptions filled (75 million) from total prescriptions filled (537 million). She then assumed an average \$10 co-payment and multiplied that average co-payment by the number of retail prescriptions filled to get \$4.6 billion.”).

173. *Id.* at 270 n.7 (“[Plaintiff] makes much of the difference between the estimated \$4.6 billion and the actual \$5.54 billion, but had the *Journal* reporter used a slightly higher average co-payment, this difference would have been smaller. She noted that ‘\$10 to \$15 is typical in the industry.’ [Barbara Martinez, *Merck Included Co-Payments Among Revenue*, WALL ST. J., June 21, 2002, at C1]. Had she used \$12.50, the average of \$10 and \$15, she would have come up with \$5.78 billion.”).

174. Barbara Martinez, *Merck Included Co-Payments Among Revenue*, WALL ST. J., June 21, 2002, at C1 (“Merck won’t disclose its average co-payment amount, though most co-payments industrywide fall between \$5 and \$50.”).

175. I am assuming, of course, that a court would not conclude that \$5.54 billion is an immaterial amount of revenue. This is, of course, an alternative “out” for defendants—that the amount itself is immaterial. Notably, none of the relevant cases discussed in this paper took that approach. Rather, they said, in one form or another, that failure to disclose the bottom line was an immaterial omission because it could have been calculated from the disclosed data.

question of fact precluding dismissal or grant of summary judgment. On the one hand, there are facts supporting the conclusion that the market did the math and found it immaterial.¹⁷⁶ For example, Merck's stock price was not running up in the period between announcement of the planned Medco IPO and public disclosure of Medco's revenue recognition practice. Merck's stock price on January 2, 2002, the day the Medco IPO was announced, closed at \$59.76.¹⁷⁷ By April 17, 2002, the day Merck disclosed the revenue recognition practice, the price had dropped to \$55.05.¹⁷⁸ This could suggest that the misrepresentation regarding Medco's revenue recognition policies was not material.¹⁷⁹ However, Medco's revenue recognition practice had been going on long before the IPO announcement, so it would take further analysis to determine whether price inflation had already been incorporated into the market price.¹⁸⁰ Furthermore, while the stock price dropped from \$52.20 to \$49.98 following the *Journal* article,¹⁸¹ many analysts viewed this simply as market "panic."¹⁸² However, at least one downgraded Merck's

176. *Merck*, 432 F.3d at 270-71.

177. Yahoo Finance, Merck & Co. Inc. (Jan. 2, 2002), <http://finance.yahoo.com/q/hp?s=Mrk> (enter "January 2, 2002" in "set date range" for start date and end date) (last visited Feb. 7, 2007).

178. *Id.* (enter "April 17, 2002" in "set date range" for start date and end date) (last visited Feb. 7, 2007).

179. See *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1306 (C.D. Ca. 1996) ("[T]he fact that the stock price rose dramatically while the market was receiving the alleged misstatements . . . support[s] the conclusion that the false statements were 'material.'").

180. See Barbara Martinez, *Merck Booked \$12.4 Billion It Never Collected—Co-Payments to Pharmacies Lifted Drug Giant's Revenue; Firm Stands by Treatment*, WALL ST. J., July 8, 2002, at A1 ("The company didn't disclose how much it may have booked in revenue from co-payments from 1993 to 1998. Merck acquired Medco in 1993.").

181. Ed Silverman, *Merck Stands by Medco Accounting: Stock Falls 4%; Medco IPO Set for Next Week*, STAR-LEDGER, June 22, 2002, <http://www.vaccinationnews.com/DailyNews/June2002/MerckStandsByMedcoAcct22.htm> ("Merck stock fell \$2.22, or 4.25 percent, closing at \$49.98, a new four-year low, on more than twice the normal daily trading volume. The report first appeared in yesterday's Wall Street Journal.").

182. See, e.g., *Merck-Medco Spinning Off From Parent Amid Revenue Recognition Controversy; Future Uncertain*, Drug Cost Management Report, July 2002, http://findarticles.com/p/articles/mi_mONKV/is_7_3/ai_89237275 ("While some investors may be spooked by any critique of PBM accounting practices in the post-Enron era, many analysts are advising that the revenue recognition issue has no bearing on the stock value for either Merck & Co. or Medco Health Solutions."); *Merck Sinks on Medco Report*, USA TODAY.com, June 21, 2002, <http://www.usatoday.com/money/health/2002-06-21-merck-medco.htm> ("In general, investors in pharmacy benefits managers who understand the financials of these companies do not look at revenue in their assessment," said Banc of America Securities analyst Patrick Hojlo. . . . "To portray this as an attempt to mislead investors is a big stretch," Hojlo said about Merck's accounting policy."); Silverman, *supra* note 181 ("Analysts were divided over the ramifications, but few were surprised at Wall Street's reaction, given ongoing concerns over accounting practices at large companies. . . . One tax expert, however, said Merck didn't appear to violate accounting rules and that investor reaction may have been overblown. 'I think they're accounting for revenue correctly,' said Robert Willens, a tax and accounting analyst at

stock in response to the *Journal* disclosure.¹⁸³ Furthermore, there can be little doubt that Merck pushed its revenue numbers in painting a rosy picture of its own future. For example, in a 2000 press release, the company repeatedly stressed its revenue growth:

Merck has created a strong platform for growth and is delivering outstanding performance, Merck Chairman, President and CEO Raymond V. Gilmartin told more than 300 securities analysts today at the Annual Business Briefing. "As a company, Merck is totally focused on growth," said Mr. Gilmartin. "And, we have made significant investments in those areas that can enable us to achieve our goal to be a top-tier growth company over the long term: cutting-edge science, strong and innovative new products, and *Merck-Medco, the nation's leading provider of pharmacy care*. "We are now seeing exceptional evidence of our strength and our future potential," Mr. Gilmartin said. In six of the last seven quarters, Merck's revenue growth for its pharmaceutical and vaccine businesses worldwide ranked either No. 1 or No. 2 within the industry. For the last three consecutive quarters, Merck's revenue growth ranked No. 1 in the pharmaceutical industry.¹⁸⁴

And, the amount of revenue in question here was certainly not insignificant. "The co-payments that Medco booked as revenue at retail pharmacies in 2001 amounted to \$5.5 billion, representing 11% of Merck's 2001 overall revenue of \$50.69 billion."¹⁸⁵ The total revenue booked but never actually collected by Merck under this accounting method in the years 1999—2001 was \$12.4 billion.¹⁸⁶

Lehman Bros. "There's been a lot of legitimate accounting issues raised lately, but this doesn't strike me as one of them." For the same reason, Hemant Shah, an independent securities analyst who tracks the drug industry, downplayed the disclosure. "Certainly, people may be more cautious toward the offering," said Shah. "But this practice doesn't effect net income or cash flow. So at the end of the day, it's a non-issue."); *Drug Giant Merck Misled on Revenues*, THE STANDARD-TIMES, July 9, 2002, at A13, <http://www.s-t.com/daily/07-02/07-09-02/a13bu069.htm> ("Analysts weren't too concerned, suggesting that many investors were simply locking in profits from Friday's big advance.") [hereinafter *Drug Giant*].

183. *Drug Giant*, *supra* note 182, at A13 ("Merck, based in Whitehouse Station, N.J., said yesterday its treatment was in accord with generally accepted accounting practices and had no impact on its earnings since the revenue was offset in its financial reports as an expense. But its stock fell amid heightened investor suspicion about accounting issues. The stock closed down \$1.05 to \$47.81. Meanwhile, Merrill Lynch downgraded the stock, citing the possibility of a delay in the planned spinoff of its Merck Medco unit.").

184. *Merck Cites Strong Growth in Presentation to Analysts: Momentum of Key Products Fuels Confidence in Company's Future*, PRNewswire, Dec. 12, 2000, http://www.presseportal.de/story_rss.htm?nr=202685&firmid=8150 (emphasis added); see also 5B ARNOLD S. JACOBS, LITIGATION AND PRACTICE UNDER RULE 10B-5 § 61.02[c], at 3-193 (West 1999) ("[A] company deciding to issue a press release shows that the company thought the data were significant.").

185. Martinez, *supra* note 180, at A1.

186. *Id.*

While the Third Circuit opined that it was impossible for the market to have failed to calculate these amounts immediately upon disclosure of Medco's revenue recognition practice,¹⁸⁷ the *Journal* concluded that "[t]hough the revenue-recognition policy was disclosed within Merck's 200-page SEC filing in April, the policy wasn't widely known by investors or Wall Street analysts until it was reported by *The Wall Street Journal* [on June 21st]."¹⁸⁸ While the Third Circuit scoffed at what it saw as plaintiffs' argument that "investors and analysts stood in uncomprehending suspension for over two months until the *Journal* brought light to the market's darkness,"¹⁸⁹ it seemed in the same breath to be saying that an article appearing on the front page of the *Journal*'s "Money & Investing" section (in the popular "Heard on the Street" column) was not news. The Third Circuit framed the issue as "whether needing [some] mathematical proficiency to make sense of the [policy] disclosure negates the disclosure itself."¹⁹⁰ However, a better statement of the issue would have been whether disclosure of the fact of a revenue recognition policy, plus enough data to calculate the bottom line impact of that policy (given the making of an accurate assumption), equals disclosure of that bottom line so as to constitute complete disclosure.¹⁹¹ One seemingly cannot answer that question without looking deeper than simply whether the data was disclosed. One would need to know where and how the data was disclosed and whether it was disclosed in such a manner as to make calculation reasonably likely—the Reasonably Available Data rule would have required such an inquiry.

There was also an allegation that Medco's accounting practices violated Generally Accepted Accounting Practices ("GAAP").¹⁹² Given that this was

187. *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 270-71 (3d Cir. 2005) ("[T]he added, albeit minimal, arithmetic complexity of the calculation hardly undermines faith in an efficient market. . . . An efficient market for good news is an efficient market for bad news. The *Journal* reporter simply did the math on June 21; the efficient market hypothesis suggests that the market made these basic calculations months earlier.").

188. Martinez, *supra* note 180, at A1.

189. *Merck*, 432 F.3d at 270.

190. *Id.*

191. One could also frame the issue as whether the disclosure of the data necessary to calculate the bottom line was sufficient to conclude that had Merck additionally disclosed the multi-billion dollar impact, the total mix of information available to investors would not have significantly altered. See *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1115 (9th Cir. 1989) ("We conclude that in a fraud on the market case, the defendant's failure to disclose material information may be excused where that information has been made credibly available to the market by other sources. The issue with regard to the bulk of Apple's misstatements is whether, in light of the press' documentation of Lisa's risks, a rational jury could nonetheless find a 'substantial likelihood' that full disclosures by Apple would have 'significantly altered the 'total mix' of information made available.'" (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (9th Cir. 1989))).

192. See Stanford Law School Securities Class Action Clearinghouse, Company and Case

a motion to dismiss, the court was required to “accept as true all facts alleged in the complaint.”¹⁹³ Other cases have held that an overstatement of revenues in violation of GAAP “can constitute a false or misleading statement of material fact necessary to establish a Section 10(b) and Rule 10b-5 violation.”¹⁹⁴ Even though Merck stated publicly that its accounting in the matter was “entirely appropriate because it ha[d] a residual legal liability” in connection with the co-payments and Medco met “various ‘indicators’ spelled out in the accounting rules for booking such revenue,”¹⁹⁵ various financial experts stated that the booking of such uncollected revenue “overstates total economic activity at the company” and that for “a PBM that has no legal liability for the co-payment, has no risk for the co-pay and in fact never ever receives the co-payment, it would not be appropriate under GAAP . . . to report this revenue.”¹⁹⁶ Regardless, even if Merck was technically in compliance with GAAP, that does not insulate the company from liability.¹⁹⁷ Most likely, the appropriateness of Merck’s revenue recognition practice is a subject on which reasonable minds can differ.¹⁹⁸

Information, Merck & Co., Inc., <http://securities.stanford.edu/1024/MRK02-01/>.

193. *Merck*, 432 F.3d at 266.

194. *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1305 (C.D. Cal. 1996) (citing *Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994)); see *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 572-76 (2d Cir. 1982).

195. Martinez, *supra* note 174, at C1; see also Martinez, *supra* note 180, at A1 (“Merck contends that it has legal liabilities for the co-payment under certain circumstances, such as if it transmits electronically to the pharmacist incorrect information about how much co-payment the pharmacist should collect. But in its SEC filing, the company said it doesn’t face a ‘credit risk,’ which would force it to reimburse pharmacies if a customer skipped out on making the co-payment.”).

196. Martinez, *supra* note 174, at C1 (quoting Charles Mulford, director of financial analysis program, Georgia Institute of Technology, and Lynn Turner, director, Center for Quality Financial Reporting, Colorado State University); see also *Merck-Medco Spinning Off From Parent Amid Revenue Recognition Controversy; Future Uncertain*, DRUG COST MANAGEMENT REPORT, July 2002, http://findarticles.com/p/articles/mi_m0NKV/is_7_3/ai_89237275 (“[S]ome accounting experts believe that including copayments on the PBMs [sic] statement is misleading, because it inflates the gross revenue figures for both the PBM subsidiary and it’s [sic] parent company.”); Martinez, *supra* note 180, at A1 (“‘For a company such as Merck to reflect as revenues in its financial statements billions of dollars of co-payments a customer makes directly to another company, the pharmacy, which the pharmacy collects and never remits to Merck, just does not reflect the economics of what is occurring,’ said Lynn Turner, a former chief accountant at the SEC who is now an accounting professor and director of the Center for Quality Financial Reporting at Colorado State University in Fort Collins. ‘If that is what the SEC accepts, then investors are in trouble and our financial reporting indeed needs improving,’ he said.”).

197. Martinez, *supra* note 180, at A1 (“Medco’s accounting practice echoes a recent case involving Edison Schools Inc., a commercial operator of public schools, which was booking as revenue funds that school districts paid directly for teacher salaries and other costs. The SEC in May found that Edison ‘failed to disclose that a substantial portion of its reported revenues consist of payments that never reach Edison.’ Although Edison’s accounting practice, which didn’t affect net income, conformed to generally accepted accounting principles, the SEC said that ‘technical compliance with GAAP’ doesn’t insulate a company from enforcement action if it makes filings ‘that mischaracterize its business or omit significant information.’”).

198. See *In re Digi Int’l, Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1098 (D. Minn. 1998) (“Plaintiffs allege that defendants’ use of the note receivable method was not only mistaken, but also clearly

All this suggests the better result would have been to deny the motion to dismiss. The Reasonably Available Data rule would have led to that result.

Compare the approach the Third Circuit took in *Merck*, with that of the district court in *Marksman Partners, L.P. v. Chantal Pharmaceutical Corp.*¹⁹⁹ *Marksman* involved facts very similar to those in *Merck*: the court was ruling on a motion to dismiss a Rule 10b-5 claim involving allegations of revenue inflation via booking consignment sales which were subject to a right of return.²⁰⁰ The agreement containing the terms of the consignment deal was disclosed by Defendant as part of its 1995 10-K.²⁰¹ However, it was not until a *Barron's* article revealed the accounting implications of the agreement that the market reacted negatively.²⁰² In discussing the claim, the *Marksman* court noted that:

Materiality of information in a Section 10(b) and Rule 10b-5 case is ordinarily a jury question, requiring an assessment of the inferences that a reasonable shareholder would draw from a given set of facts.

inappropriate with regard to the AetherWorks investment; defendants respond that the appropriate method of accounting for the AetherWorks investment was open to interpretation during the class period. The evidence, in the form of expert testimony or otherwise, ultimately may prove defendants to be correct, but the Court cannot resolve this issue on a motion to dismiss.”); Martinez, *supra* note 180, at A1 (“The benefits to Medco of including co-payments as revenues aren’t clear cut. The accounting treatment, while making Medco’s revenue look larger, actually decreases its gross-profit margins compared with some of its competitors, which is the opposite of what investors generally like to see. However, some competing pharmacy-benefit managers and customers say that large revenues and a lower gross margin are more attractive to potential clients, because they indicate that a company can handle large volumes and that it passes on more of its profits to its customers.”).

199. 927 F. Supp. 1297 (C.D. Cal. 1996).

200. *See id.* at 1301 n.1 (“A consignment sale is one in which goods are delivered by a consignor to a dealer or distributor (the consignee) primarily for sale by the consignee, and the consignee has the right to return any unsold commercial units of the goods in lieu of payment. Because a product return cancels the sale, any sale made with the right of return creates doubt about whether the transaction actually constitutes an exchange.”) (internal citations omitted). *Cf. Malone v. Microdyne Corp.*, 26 F.3d 471, 478 (4th Cir. 1994) (“We cannot find a single precedent, however, holding that a company may violate FAS 48 and substantially overstate its revenues by reporting consignment transactions as sales without running afoul of Rule 10b-5. The case law clearly states that such a company may be held liable under § 10(b) and Rule 10b-5 for making false or misleading statements of material fact.”); *see also Sirota v. Solitron Devices, Inc.*, 673 F.2d 566, 572-76 (2d Cir. 1982) (holding defendants liable for securities fraud because they reported consignment transactions as sales); *Bernstein v. Crazy Eddie, Inc.*, 702 F.Supp. 962, 970-71 (E.D.N.Y. 1988) (stating that it is a “fraudulent practice[]” to treat as sales “[t]ransactions that were really consignments”).

201. *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1302 (C.D. Cal. 1996).

202. *Id.* at 1303 (“On January 6, 1996, Chantal’s well-publicized rise came to an abrupt halt. On that date, the financial journal *Barron's* published an article questioning Chantal’s accounting and whether Chantal’s reported revenues represented a true sale, since the risk of ownership of the products did not appear to have transferred from Chantal to Stanson. Two days later, on January 8, 1996, Chantal’s stock lost 62% of its value, going from \$19.125 to \$7.31 per share on a trading volume in excess of 7,000,000 shares.”) (internal citation omitted).

As such, a complaint may not be properly dismissed pursuant to Rule 12(b)(6) on the grounds that the alleged misstatements or omissions are not material unless they are “so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance.”²⁰³

In addressing Defendant’s argument that disclosure of the marketing agreement cured the earlier misrepresentations, the *Marksman* court agreed that true statements could cure false ones but stressed that the disclosure of the truth must be of an “intensity and credibility sufficient to effectively counterbalance any misleading impression” created by a defendant’s earlier misrepresentation.²⁰⁴ Because “[t]o immunize the type of conduct alleged here would be to give companies a license to issue groundless appraisals to investors so long as they include a modest footnote or appendix with a kernel of truth that might enable an analyst or accountant to spot the inconsistencies,” the court declined to dismiss the action.²⁰⁵

Obviously, there are a number of facts upon which *Merck* and *Marksman* could be distinguished. However, is it at all clear that the *Merck* court was justified in essentially foregoing any analysis of the reasonable availability of the bottom line via calculation simply because it was dealing with a math case? In certain cases, that may be the correct approach. In *Merck*, however, the lack of rigor arguably led to the wrong result. Another case that may suggest that a more fine-tuned rule is necessary for Simple Math cases is *Kramer v. Time Warner, Inc.*²⁰⁶

In *Kramer*, Time Incorporated (“Time”), in connection with its planned merger with Warner Communications, Inc. (“Warner”), “mailed to Warner shareholders a formal offer to purchase contained in a Schedule 14D-1 (collectively ‘Offer to Purchase’) filed with the SEC.”²⁰⁷ As part of the planned merger, certain Warner executives were to gain handsomely under an incentive plan, which employed a combination of “Equity Units” and options to compensate the executives.²⁰⁸ Plaintiff claimed the details of this

203. *Id.* at 1305-06 (quoting *Goldman v. Beldon*, 754 F.2d 1059, 1067 (2d Cir. 1985)) (internal citations omitted).

204. *Id.* at 1306 (quoting *In re Apple Computer Sec. Litig.*, 886 F.2d 1109, 1116 (9th Cir. 1989)).

205. *Id.* at 1307.

206. 937 F.2d 767 (2d Cir. 1991).

207. *Id.* at 770.

208. *Id.* at 771 (“In 1982, Warner’s shareholders approved an Equity Unit Purchase Plan (‘Equity Plan’) under which high-level Warner executives could purchase blocks of equity interest in the company, each block consisting of seventy-five shares of Warner common stock (‘Equity Unit’). Payment for Equity Units could be made by cash or promissory note. Under the Equity Plan, purchasers were obligated eventually to resell their Equity Units to Warner at a resale price roughly equal to the aggregate book value of the common stock contained in the Units. The Equity Plan gave the Executive Compensation Committee of Warner’s board of directors the discretion to modify the resale price under certain circumstances. In addition to purchases under the Equity Plan, Warner’s top managers also were issued, at various times, options to purchase shares of Warner

plan were insufficiently disclosed to inform shareholders of potential conflicts of interest. Specifically, the plaintiff alleged that the Offer to Purchase merely stated the per-share-price at which the executive's Equity Units would be purchased (\$70), but did not mention the then-current resale price (\$5.19), the number of shares held by the executives (700,000), or the original purchase price (\$10.00).²⁰⁹ "These omissions, Kramer asserted, concealed the magnitude of the profits accruing to the individual defendants from the adjustment of the resale price in the Equity Plan."²¹⁰ "Kramer argues that had he known that the individual defendants owned Equity Units representing thousands of shares of Warner stock, the resale price of which would be adjusted from \$5.19 to \$70.00 per share, he would have viewed the Warner directors' recommendation to accept Time's offer differently."²¹¹

The Second Circuit recognized that inside director gain in connection with a recommended transaction constituted material information.²¹² Additionally, and particularly relevant for purposes of our discussion here, the court recognized that the magnitude of the gain could also constitute material information.²¹³ Despite this, the court concluded that the information regarding the magnitude of the inside directors' gain was properly disclosed. The Offer to Purchase, mailed June 19, 1989, was arguably deficient, and its generic references to the Joint Proxy Statement were insufficient to alert shareholders to the relevant material information contained therein (data allowing a calculation of the directors' gain). However, a letter mailed by Warner to its shareholders in connection with the Offer to Purchase included a Schedule 14D-9. The Schedule 14D-9 incorporated by reference the Joint Proxy Statement issued on May 24, 1989, and alerted the shareholders to information therein regarding "certain contracts, agreements, arrangements or understandings between [Warner] . . . and certain of [its] directors . . . [and] executive officers."²¹⁴ The Second Circuit recognized that this crumb-trail of disclosure was "not ideal," but nonetheless found it sufficient.²¹⁵ But is this really "full and fair" disclosure? If you were a Warner shareholder, would you understand the Securities Regulations to require no more disclosure regarding interested

common stock at various specified prices.").

209. *Id.*

210. *Id.* at 772.

211. *Id.* at 777.

212. *Id.*

213. *Id.*

214. *Id.* at 778.

215. *Id.*

directors' financial gain from a recommended transaction?²¹⁶ Had the court applied the Reasonably Available Data rule proposed here, it would have had to ask more questions. Specifically, it would have had to ask whether the data necessary to calculate the magnitude was: (1) disclosed proximately to where a reasonable investor would expect to find it (it was not); (2) reasonably available—particularly whether it was cross-referenced to in some meaningful way (arguably, it was); and (3) disclosed in such a way as to highlight its import (seemingly, an open question of fact).

Another case from the Third Circuit that may suggest a need for a more analytically rigorous rule is *Werner*.²¹⁷ In that case, management recommended approval of a buy-out without disclosing the magnitude of the benefit that would inure to them if they deleted a right of first refusal under a restricted stock plan.²¹⁸ The court concluded that failure to disclose the magnitude was an immaterial omission because the information was still accessible through a six-step process: First, the 1997 proxy disclosed the planned removal of the right of first refusal.²¹⁹ Second, “a reasonable shareholder should have realized that management would get a higher price for their shares by deleting the right of first refusal.”²²⁰ Third, shareholders then “only had to look to the 1993 and 1994 annual reports to determine how many shares were issued each year pursuant to the Restricted Stock Plan.”²²¹ Fourth, “[u]sing those same reports, shareholders could determine the approximate fair market value (‘FMV’) of Restricted shares at the date of issuance.”²²² Fifth, shareholders could then employ the equation “[(FMV 1997 - FMV in 1993) x number of shares issued in 1993] + [(FMV 1997 - FMV 1994) x number of shares issued in 1994]” in order to “compute the amount of money the management defendants would have gotten for their shares had the right of first refusal been exercised.”²²³ Finally, “shareholders could then compare the amount yielded by the above equation to the \$66 million the management defendants would actually receive in the Recapitalization as proposed.”²²⁴ Many may conclude that if this six-part formulation can constitute full and fair disclosure, then the reasonable

216. *Cf. Robinson v. Penn Cent. Co.*, 336 F. Supp. 655, 657 (“If that [material information] is in the present proxy material, it is too well encoded to be meaningful.”); *id.* at 658 (“The facts must be fully and explicitly disclosed. . . . Conclusory statements and bare facts without a disclosure of the key issues involved at arriving in an intelligent decision will not satisfy the requirements of § 14(a), or S.E.C. Rule 14a-9.”).

217. 267 F.3d 288 (3d Cir. 2001).

218. *Id.* at 299.

219. *Id.*

220. *Id.*

221. *Id.* at 299-300.

222. *Id.* at 300.

223. *Id.*

224. *Id.*

investor may need to consider quitting his or her day job so as to allow enough time for this game of hide-and-seek with the truth.²²⁵

Nevertheless, the court concluded that because shareholders could compute the magnitude of the benefit inuring to management via removal of the right of first refusal, the failure to disclose this magnitude was immaterial.²²⁶ There was little examination of where or how the data needed for the calculation was disclosed. Rather, the simple fact that it was disclosed in some way that was accessible to shareholders was enough for the court. Again, had the Reasonably Available Data rule been applied, the motion to dismiss likely would have been denied.

The preceding discussion should not lead the reader to conclude, however, that the proposed rule would never allow for dismissal where the data necessary to calculate the bottom line is disclosed in a dispersed manner. Consider *Ash v. LFE Corp.*²²⁷ There, the issue again was director interest in a recommended transaction proposed to shareholders, this time concerning revision of a pension plan.²²⁸ The proxy statement set forth the existing remuneration of the directors in tabular form, including annual expected retirement benefits.²²⁹ This disclosure included a cross-reference to the new proposed plan.²³⁰ Following this reference would lead the shareholder to a disclosure setting forth the annual expected retirement benefits under the new proposed plan.²³¹ Even though the total gain to directors was not explicitly disclosed, the court found no violation because all that was required of the shareholder to determine the gain to the directors was to perform the “simple arithmetical computation” of subtracting the old

225. An obvious rebuttal here is that it is precisely because individual investors do not have the time to work their way through the plethora of documents they are inundated with, due to the very disclosure rules designed to protect them, that a rule like the Reasonably Available Data rule is impractical. However, as long as the focus of security regulation's materiality analysis is the reasonable investor, it is no real argument to say “they won't read it.” To the extent defendants should be protected on that ground, reliance provides sufficient cover. Furthermore, it seems fair to argue that the more explicitly material information is disclosed, the less time it will take that information to reach the market, thereby reducing the arbitrage opportunities of sophisticated investors—which will likely be taken at the expense of average investors. Cf. STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 180 (Foundation 2005) (“The Commission adopted Regulation FD to level the playing field for all investors with respect to the disclosure of material, nonpublic information by issuers. . . . Prior to Regulation FD, small investors were often disadvantaged because they did not have equal access to such information at the same time as large institutional investors and other securities industry professionals.”).

226. *Werner v. Werner*, 267 F.3d 288, 300 (3d Cir. 2001).

227. 525 F.2d 215 (3d Cir. 1975).

228. *Id.* at 217.

229. *Id.* at 218.

230. *Id.*

231. *Id.*

benefit from the new.²³² Applying the Reasonably Available Data rule to the facts of this case should produce the same result. While the necessary data was not disclosed proximately, it was cross-referenced and its import was readily discernable.²³³

C. *The Corrective Disclosure Cases*

Where a defendant is seeking to rely on the Simple Math rule in order to avoid liability following an affirmative misstatement (as opposed to the situation where the only alleged misdeed is failure to disclose the bottom line), that fact should count as a separate factor against the defendant. This is so because an investor should reasonably be able to expect disclosure of the magnitude of a correction where that magnitude is material. Not disclosing the magnitude as part of a corrective disclosure is akin to saying, for example: “Yes, we violated a technical rule, but the magnitude of the error is so minor we need not even bother you with it.”²³⁴ The weighing of this factor against defendants is not new. For example, in *United Paperworkers International Union*, the Second Circuit noted that incomplete disclosure would not have been found to be material if, among other things, “the Company’s misleadingly self-laudatory statements [had] not been made”²³⁵

In *In re Digi International, Inc.*, plaintiffs claimed Digi International, Inc. (“Digi”), improperly accounted for certain transactions so as to artificially inflate earnings.²³⁶ Specifically, plaintiffs challenged Digi’s use of the “note receivable” method to account for a particularly risky multi-million dollar investment (by means of a convertible secured note) in a development stage company named AetherWorks.²³⁷ Plaintiffs argued that Digi should have used the “equity method” to account for its investment in AetherWorks.²³⁸ Prior to the litigation, in an announcement dated November 14, 1996, Digi suggested this was correct when it “indicated that

232. *Id.* at 218-19 (“We decline to hold that those responsible for the preparation of proxy solicitations must assume that stockholders cannot perform simple subtraction.”).

233. *Compare id.* at 219 (noting that the failure to do the math for shareholders in *Ash* was immaterial as matter of law because the data necessary to perform the relevant calculations was “disclosed prominently and candidly”), with *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 270 (3d Cir. 2005) (“The calculation from Merck’s S-1 was somewhat more complex—it required some close reading and an assumption as to the amount of the co-payment.”).

234. *Cf.* David Reilly, *No More ‘Stealth Restating’*, WALL ST. J., Sept. 21, 2006, at C1 (“By failing to properly file disclosures related to restatements, companies hope investors ‘may dismiss a restatement as relatively minor,’ because it was tucked ‘away quietly in the current period’s results,’ research firm Glass Lewis & Co. said in a report earlier this year. ‘Clearly, companies know this—and many take advantage,’ that report noted.”).

235. *United Paperworkers Int’l Union v. Int’l Paper Co.*, 985 F.2d 1190, 1200 (2d Cir. 1993).

236. *In re Digi Int’l, Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1093 (D. Minn. 1998).

237. *Id.* at 1093-94.

238. *Id.* at 1094.

if it were required to apply the equity method of accounting, Digi's share of AetherWorks' fourth quarter operating losses would range from \$0.15 to \$0.20 per share."²³⁹ In making this announcement, however, "Digi did not indicate . . . what effect application of the equity method would have on stated earnings for the first three quarters of fiscal year 1996."²⁴⁰ Digi's stock declined only modestly after this announcement.²⁴¹

On December 23, 1996, Digi disclosed that it would have to restate its quarterly financial reports for the first three quarters.²⁴² Digi acknowledged it should have used the equity method to account for its investment in AetherWorks, and that its actual earnings for 1996 would end up approximately thirty-seven percent below what had been previously reported.²⁴³ The market reacted strongly to this announcement, with Digi's stock dropping sharply.²⁴⁴

In defending against plaintiffs' claims, Digi argued its announcement on November 14th (that it was considering use of the equity method) cured any earlier misstatements regarding its accounting.²⁴⁵ The court, however, concluded that "Digi's November 14, 1996 press release did not set forth with sufficient completeness or clarity the 'bad news' regarding AetherWorks to cure all of the misperceptions created by Digi's earlier disclosures."²⁴⁶ Specifically, Digi's November 14th announcement, among other things, "did not discuss the potential effect of the change in accounting treatment on the results of the first three quarters of 1996"²⁴⁷ Thus, the court held that "the November 14 press release was not sufficiently accurate or complete to cure, as a matter of law, Digi's previous omissions and misleading financial statements regarding AetherWorks."²⁴⁸

Digi was decided via implicit application of the truth-on-the-market doctrine. Some may argue that the truth-on-the-market doctrine provides sufficient analytical rigor where defendants claim that disclosure of the truth should cure a prior falsity by placing the burden on defendants to prove that the truth was disseminated with sufficient intensity and credibility to "effectively counterbalance any misleading impression created by insider's

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.*

243. *Id.*

244. *Id.*

245. *Id.* at 1102.

246. *Id.*

247. *Id.*

248. *Id.*

[sic] one-sided representations.”²⁴⁹ However, as discussed in more detail elsewhere in this paper, because the truth-on-the-market doctrine is best seen as a means for defendants to rebut the fraud-on-the-market presumption, its applicability to the materiality determinations at issue here should be limited.²⁵⁰

This is not to say that, as also discussed above, disclosure of the truth cannot be used to demonstrate immateriality under the total mix analysis. The question then, however, is more fact specific—focusing on the impact of the disclosure on the reasonable investor. Also, the Reasonably Available Data rule is arguably better suited to address calculation cases than the truth-on-the-market doctrine, because its decision-tree analysis is specifically designed for cases involving mathematical calculations based upon disclosed data. While it is certainly better to ask whether the data was disclosed with sufficient credibility and intensity to offset an earlier misleading disclosure than to simply ask whether it was disclosed, there is still a lot of uncertainty that remains as to what will constitute sufficient credibility and intensity. In a sense, the Reasonably Available Data rule defines this phrase in a way uniquely suited to the analysis of Simple Math cases.

In terms of practical application, when applying the Reasonably Available Data rule in cases involving corrective disclosures courts should count the failure to state the bottom line as a separate factor against finding that the import of the relevant data was sufficiently highlighted. In fact, a court should be reluctant to grant a motion to dismiss under the Reasonably Available Data rule in such a situation where the cross-reference to the data did anything short of stating, in effect, “this is important.” Obviously, this is a further argument suggesting *Merck* was wrongly decided.²⁵¹

249. *Provenz v. Miller*, 102 F.3d 1478, 1492-93 (9th Cir. 1996) (quoting *Kaplan v. Rose*, 49 F.3d 1363, 1369 (9th Cir. 1994)).

250. See *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 161 (2d Cir. 2000) (“At the pleading stage, a plaintiff satisfies the materiality requirement of Rule 10b-5 by alleging a statement or omission that a reasonable investor would have considered significant in making investment decisions.”); *Marksman Partners, L.P. v. Chantal Pharm. Corp.*, 927 F. Supp. 1297, 1307 n.6 (C.D. Cal. 1996) (“It is true that a defendant may sometimes be able to rebut the presumption of reliance in a fraud-on-the-market action under Section 10(b) and Rule 10b-5 by showing that sophisticated buyers, or market makers, were not taken in by the misrepresentations at issue. . . . [However], the market maker perspective has no bearing on the question of materiality, which is based instead on the perspective of a reasonable investor.”) (internal quotations omitted); *Robinson v. Penn. Cent. Co.*, 336 F. Supp. 655, 657 (E.D. Penn. 1971) (“It may be that a sophisticated analyst, with knowledge of the corporate world, would ultimately deduce from the proxy material [the material information]. However, our concern is not the sophisticated analyst, but the reasonable stockholder . . .”).

251. To be precise, whether *Merck*’s disclosure of the details of *Medco*’s revenue recognition practices was a corrective disclosure is more properly regarded as a question of fact, since *Merck* maintained the practice was proper. However, at the pleading stage such factual disputes should be viewed in the light most favorable to plaintiffs. See *In re Merck & Co. Sec. Litig.*, 432 F.2d 261, 266 (3d Cir. 2005).

D. The Delayed Reaction Cases

The fourth group of cases are those where a significant market reaction follows disclosure of the bottom line, when there was no reaction to an earlier disclosure of the data sufficient to calculate that bottom line. In those cases, plaintiffs may be precluded from arguing that the market took time to digest the data because a court may conclude that such an argument destroys the basis for (where applicable) plaintiffs' fraud-on-the-market presumptive reliance.

For example, the Third Circuit in *Merck*, responding to just such an argument, concluded that "[plaintiff] is trying to have it both ways: the market understood all the good things that Merck said about its revenue but was not smart enough to understand the [revenue] disclosure."²⁵² I argue, however, that because the very crux of these cases is that the bottom line was *not* disclosed, the failure of the market to "do the math" immediately should not deprive plaintiffs of the fraud-on-the-market presumption in light of the policy reasons in favor of the presumption and the type of market efficiency necessary for the fraud-on-the-market presumption. In fact, once the issue is properly framed in terms of whether the data was disclosed in such a manner as to allow it to serve as proxy for disclosure of the bottom line, the fact that the market reacted negatively to the eventual explicit disclosure to that bottom line should count in plaintiffs' favor.²⁵³

The argument in favor of not equating the market's failure to immediately react to disclosure of data sans bottom line, with failure of the plaintiff to meet the efficient market requirement of the fraud-on-the-market presumption has a number of points to support it. First, it must be remembered that there is a strong policy reason supporting the fraud-on-the-market presumption.

The first and most important area in which courts use efficiency as a descriptive concept is the "fraud-on-the-market" theory. This theory developed out of a problem confronting plaintiffs in Rule 10b-5 litigation. Because these plaintiffs were generally investors holding passive positions, most individuals' losses were likely to be small. Consequently, no single investor could expect to benefit

252. *Id.* at 270.

253. See No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 935 (9th Cir. 2003) ("Moreover, although America West's disclosures of the settlement agreement had no immediate effect on the market price, its stock price dropped 31% on September 3, 1998 when the full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed to the market. This reaction, even if slightly delayed, further supports a finding of materiality.").

from bringing an action because, in all likelihood, the costs of litigation would far outweigh any potential recovery. Class action litigation offered a solution to this problem. By aggregating claims in a class action, it would be economically viable to pursue Rule 10b-5 suits that would serve as a private enforcement mechanism.²⁵⁴

The fraud-on-the-market presumption is available to plaintiffs not solely on the basis of market efficiency. Rather, like all presumptions, it arises “out of considerations of fairness, public policy, and probability, as well as judicial economy.”²⁵⁵ This policy underpinning suggests courts should be hesitant in adding unnecessary requirements on plaintiffs to gain the benefits of the presumption.

Second, “[a]ccording to the prevailing definition of market efficiency, an efficient market is one in which market price fully reflects all publicly available information.”²⁵⁶ It would be an expansion of this definition to include not only all publicly available information but also all information possibly calculated therefrom.²⁵⁷ It is arguably in recognition of this fact that courts, in evaluating defendants’ truth-on-the-market defense, ask not only whether the truth was disclosed, but also whether “the truth in the market was sufficient to counteract the alleged fraudulent impact of the statements in question.”²⁵⁸ To argue that the market’s failure to react to disclosure of the data necessary to calculate the bottom line can only mean the bottom line is either immaterial or the market is inefficient improperly assumes an answer to the very question the court should be analyzing: Was the data disclosed in a sufficiently effective manner?²⁵⁹

254. Nathaniel Carden, Comment, *Implications of the Private Securities Litigation Reform Act of 1995 for Judicial Presumptions of Market Efficiency*, 65 U. CHI. L. REV. 879, 884 (1998); see also *Basic, Inc. v. Levinson*, 485 U.S. 224, 242 (1988) (“Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.”); *Basic*, 485 U.S. at 231 (noting that the private cause of action has become an “essential tool for enforcement of the 1934 Act’s requirements”).

255. *Basic*, 485 U.S. at 245.

256. *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 10 (1st Cir. 2005).

257. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970) (setting forth the issue vis-à-vis the semi-strong form of market efficiency as “whether prices efficiently adjust to other information that is *obviously* publicly available”) (emphasis added).

258. HAZEN, *supra* note 16, at 504.

259. *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir. 1991) (“Contending there were no material misstatements or omissions to support his § 10(b) convictions, defendant argues first that the absence of any market fluctuation in Cluett stock immediately after his 13D was filed demonstrates that the information was not important to investors. . . . Turning to defendant’s first point, whether a public company’s stock price moves up or down or stays the same after the filing of a Schedule 13D does not establish the materiality of the statements made, though stock movement is a factor the jury may consider relevant.”); *State Teachers Ret. Bd. v. Fluor Corp.*, 566 F. Supp. 939, 949-50 (S.D.N.Y. 1983) (“The ‘mosaic’ concept, it would seem, is also relevant in considering the weight to be given to market movement. Certain of the projections were released in due course, and

Third, at a time when challenges to the efficient market hypothesis can be found in both the enactments of Congress²⁶⁰ and among finance experts,²⁶¹ it seems incoherent to weaken a presumption that relies on that hypothesis only to a degree²⁶² by means of an analysis that leans on it so thoroughly. To argue that a market is only efficient for purposes of the fraud-on-the-market presumption if it reacts not only to disclosed information but also to conclusions based upon adding up the pieces of those disclosures—no matter how disconnected or obscured—seemingly sets the efficiency bar higher than necessary. While this may be in fact how efficient markets operate most of the time, this level of functioning is arguably not necessary to qualify for the fraud-on-the-market presumption.

Courts have stated that the Supreme Court in *Basic, Inc. v. Levinson* left for the lower courts to decide what constitutes an efficient market for purposes of the fraud-on-the-market presumption.²⁶³ This conclusion,

the defendants have established that release of certain items of information failed to result in any significant market movement. The defendants urge the conclusion that failure of any item of information to affect market prices when it was released demonstrates as a matter of law its immateriality. While the lack of market movement certainly is persuasive evidence of immateriality, particularly with respect to the items conceded to never have been disclosed, it is not so conclusive in and of itself as to warrant dismissal of an item which may or may not be a coordinate in the 'matrix.' Lack of market effect alone fails to remove the issue of its materiality as a matter of law from the jury's consideration . . .").

260. See Carden, *supra* note 254, at 880 ("In . . . the Private Securities Litigation Reform Act of 1995 ('PSLRA'). . . Congress enacted a provision that caps the amount plaintiffs can recover in damages. This limit on damages was in response to the possibility that markets might overreact when the fraud is disclosed. Thus, the PSLRA indicates a congressional skepticism of the ECMH."); see also Jeffrey L. Oldham, Comment, *Taking "Efficient Markets" Out of the Fraud-on-the-Market Doctrine After the Private Securities Litigation Reform Act*, 97 NW. U. L. REV. 995, 998 (2003) ("[T]he PSLRA's damages provision and its underlying policies evidence a rejection of the efficient market theory as a descriptive theory of the marketplace.").

261. See Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135, 136 (2002) ("[F]aith in the EMH among economists has been weakening for some time. That is not new news; by the mid-1980s, the notion of market efficiency was already under attack by finance scholars of considerable prominence. Since then, however, the battle has turned into something akin to a siege. Critics are still increasing in visibility and numbers and seldom does an edition of one of the best finance journals appear without at least one or two major papers offering theoretical or empirical claims inconsistent with strong views of efficiency."); see also *id.* at 135 ("How was the market for such a widely followed stock [like Enron] so easily fooled, especially when (in hindsight, at least) warning signs about obscure accounting, risk-shifting, and self-dealing practices were visible?").

262. See Carden, *supra* note 254, at 887 ("If the price movement was in the proper *direction*, it is sensible to apply the presumption. The theory does not require that the *magnitude* of such a response be perfect (as the semi-strong ECMH would predict). Hence, while the existence of an informationally efficient market is a sufficient condition for the fraud-on-the-market theory to make sense (because all the information is not only incorporated, but is incorporated to such a degree that further research is futile), it is not a necessary one.").

263. *In re PolyMedica Corp. Sec. Litig.*, 432 F.3d 1, 11 (1st Cir. 2005).

however, does not flow automatically from the *Basic* opinion. A better reading of that case may be that, while the Court left certain questions regarding market efficiency unanswered, it clearly identified the minimum threshold necessary for a plaintiff to gain the benefits of the fraud-on-the-market presumption.²⁶⁴ In other words, so long as “most” publicly available information about a company is “generally” considered by market professionals, stock prices can be presumed to be sufficiently impacted by such information to warrant application of the fraud-on-the-market presumption.²⁶⁵ Following this logic, when lower courts subsequently require more, they violate the Court’s edict.²⁶⁶ Thus, the Third Circuit arguably set the bar too high when it concluded that failure of the market to react to disclosure of data-sans-impact by Merck could only mean that either the revenue recognition practice was immaterial or the market was inefficient. Given the degree of market coverage Merck receives and the multi-billion dollar impact of the disclosure, a third alternative—that the information regarding the revenue recognition practice *and* its impact were insufficiently disclosed to judge its materiality on the basis of market reaction—should at least have been considered.²⁶⁷ As the Supreme Court

264. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246-47 n.24 (1988) (“We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals *generally* consider *most* publicly announced material statements about companies, thereby affecting stock market prices.”) (emphasis added); *id.* at 247 (“Because *most* publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.”) (emphasis added); *id.* at 248 n.28 (“By accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price.”).

265. *Id.* at 247 n.24. *But see PolyMedica*, 432 F.3d at 10 (expressly rejecting such a definition in favor of one that defines an efficient market for purposes of the fraud-on-the-market presumption as “one in which the market price [of the stock] *fully reflects all* publicly available information”) (emphasis added). *Cf. Note, Recent Cases: Securities Law—Fraud-on-the-Market—First Circuit Defines an Efficient Market for Fraud-on-the-Market Purposes*, 119 HARV. L. REV. 2284, 2284-85 (2006) (“While purporting to adopt a widely accepted definition of market efficiency, the *PolyMedica* court has imposed a more stringent test for market efficiency than has heretofore been employed by courts—one that forces lower courts to determine whether a real-world market conforms at the margins to a definition of efficiency adopted from efficient capital markets scholarship and that loses sight of the goals of *Basic*.”).

266. *Cf. No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp.*, 320 F.3d 920, 946 (9th Cir. 2003) (“In this era of corporate scandal, when insiders manipulate the market with the complicity of lawyers and accountants, we are cautious not to raise the bar of the PSLRA any higher than that which is required under its mandates.”).

267. *Cf. Basic*, 485 U.S. at 249 n.29 (“We note there may be a certain incongruity between the assumption that *Basic* shares are traded on a well-developed, efficient, and information-hungry market, and the allegation that such a market could remain misinformed, and its valuation of *Basic* shares depressed, for 14 months, on the basis of the three public statements. [However, p]roof of that sort is a matter for trial . . .”). *Compare In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 270-71 (3d Cir. 2005) (suggesting that a company as widely followed in the market as Merck could be deemed to be trading in an inefficient market solely on the basis of the market’s failure to immediately calculate the impact of a disclosed revenue practice) *with Cammer v. Bloom*, 711 F.

stated in the context of Rule 14a-9 in *TSC Industries*, “[d]oubts as to the critical nature of information misstated or omitted will be commonplace.”²⁶⁸ In view of the “prophylactic purpose” of the antifraud provisions and the fact that the content of the corporate disclosure is within management’s control, it is appropriate that doubts “be resolved in favor of those the statute is designed to protect.”²⁶⁹

Finally, if one properly frames the issue as whether the relevant data was disclosed effectively enough to warrant treating it as disclosure of the bottom line, a negative market reaction to the later actual disclosure of that bottom line suggests the answer is “no.” For example, in *Ganino v. Citizens Utilities Companies*, the Second Circuit was faced with a form of delayed market reaction.²⁷⁰ In that case, Citizens Utilities Companies (“Citizens”) allegedly misrepresented earnings growth by improperly accounting for revenue received in 1995 as part of its 1996 revenue.²⁷¹ Citizens, however, claimed that the date of revenue receipt had been properly disclosed as early as April 1996.²⁷² Furthermore, Citizens claimed the lack of a market reaction following the release of its 10-Q on August 7, 1997, wherein the company disclosed the source of the contested 1996 revenue, proved the

Supp. 1264, 1286-87 (D.N.J. 1989) (setting forth a multi-factor test of market efficiency, including: (1) average weekly trading volume; (2) number of securities analysts following stock; (3) number of market makers; (4) eligibility to use Form S-3; and (5) a cause and effect relationship between significant disclosures and immediate response in stock price).

268. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 448 (7th Cir. 1976).

269. *Id.*; see also *Cione v. Gorr*, 843 F. Supp. 1199, 1205 (N.D. Ohio 1994) (“The 1934 Act was intended to protect investors against unfair manipulation of stock market prices.”) (citing S. REP. NO. 792, 73 Cong., 2d Sess., 1-5 (1934)). Cf. 4 ALAN R. BROMBERG & LEWIS D. LOWENFELS, BROMBERG & LOWENFELS ON SECURITIES FRAUD, § 7:484 (2d ed. 2001) (“It is relatively inefficient and imprecise—at trial, but even more so at class determination time—to analyze by regression analysis or other statistical techniques the response of a given security to specific information about it in order to decide if its market is efficient. There are questions about what information to test for, e.g., analysts’ opinions or advisers’ or brokers’ recommendations versus issuer’s announcements. One must somehow factor out general economic, industry and market information not specific to the security. There may be uncertainty when the information began to reach the market (e.g., by leaks, rumors or insider trading), creating doubt about the timing and amount of the response. . . . It is more reasonable to approximate efficiency by looking at the more easily identifiable or measurable characteristics that indicate the market is developed. Identifiable characteristics include the structure and communication systems of the primary market for the security: stock exchange, NASDAQ National Market System, non-NMS NASDAQ or residual over the counter. Measurable characteristics for the particular security include number of market makers (if traded off a stock exchange), number of trades, number of shares or units traded, turnover (proportion of outstanding shares or units traded in a given time), size of float, number of shareholders and number of institutional holders.”).

270. 228 F.3d 154 (2d Cir. 2000).

271. *Id.* at 158.

272. *Id.* at 168.

information itself was immaterial.²⁷³ Plaintiffs, however, noted “that Citizens’ stock price . . . experience[d] a ‘precipitous drop’ in May of 1997, when reports of Citizens’ poor earnings outlook first emerged.”²⁷⁴ The Second Circuit, noting that on a motion to dismiss all reasonable inferences must be drawn in favor of the non-moving party, concluded that the source of the stock price movement was in dispute and that it was at least possible that the misrepresentation could have caused the May stock price decline.²⁷⁵

Similarly, the court in the *Digi* case cited above viewed delayed market reaction as a factor in favor of plaintiffs. There, the market did not respond to Digi’s announcement that it was “revisiting the accounting treatment of the AetherWorks investment and indicated that it was no longer reasonable for investors to rely on previous statements regarding Digi’s financial results.”²⁷⁶ However, rather than concluding from this fact that the particular accounting practice in question was therefore immaterial (as the Third Circuit did in *Merck*), the court instead asked whether that disclosure was sufficient to “cure” the earlier accounting pronouncements.²⁷⁷ Since a later announcement disclosing the impact of the resulting accounting change caused the stock to drop sharply, the court answered that question in the negative: “[T]he substantial drop in Digi’s stock value after the December 23, 1996 announcement supports the conclusion that misperceptions in the market regarding AetherWorks and Digi were not cured until that later disclosure.”²⁷⁸

Thus, where a company discloses a particular fact along with the data necessary to calculate the bottom line impact of that fact (but not the bottom line itself), a later market reaction to disclosure of that bottom line should help, not hinder, a plaintiff’s argument that a material omission has occurred.

273. *Id.* at 166.

274. *Id.* at 167.

275. *Id.* (citing *Silver v. H & R Block, Inc.*, 105 F.3d 394, 397 (8th Cir. 1997) (“[D]eclining, on a summary judgment motion, to infer that allegedly material statements were false ‘from the movement of stock price alone . . . given the abundance of market variables’”)); *see also id.* at 167-68 (“Here, the defendants argue that the alleged inflation of 1996 income using the 1995 Fees was immaterial because Citizens’ disclosures before Class Period had already transmitted all relevant information about the HTCC deal to the market. But as explained above, the evidence on which they rely—the lack of movement in the Citizens share price after August 1997—is in dispute.”).

276. *In re Digi Int’l, Inc. Sec. Litig.*, 6 F. Supp. 2d 1089, 1102 (D. Minn. 1998).

277. *Id.*

278. *Id.*; *see also* No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 320 F. 3d 920, 935 (9th Cir. 2003) (“Moreover, although America West’s disclosures of the settlement agreement had no immediate effect on the market price, its stock price dropped 31% on September 3, 1998 when the full economic effects of the settlement agreement and the ongoing maintenance problems were finally disclosed to the market. This reaction, even if slightly delayed, further supports a finding of materiality.”).

V. CONCLUSION

In conclusion, I argue that where a securities fraud claim is based on failure to disclose the bottom line, courts should not dismiss the case solely on the ground that the data necessary to calculate the bottom line was disclosed. Rather, relying on general materiality analysis doctrine, I argue courts should ask: (1) Were all the relevant pieces of data necessary to calculate the bottom line disclosed proximately to one another in a place where a reasonable investor would expect to find them? If so, the court should stop its analysis and dismiss the case. However, if the data is not sufficiently proximate, the court should go on to ask: (2) Was the data somehow cross-referenced to? If the court concludes the data was not reasonably cross-referenced, the motion to dismiss should be denied. If the data was reasonably cross-referenced to, then the question becomes: (3) Was the import of the data sufficiently highlighted to alert the reasonable investor? Again, if the import of the data was not sufficiently highlighted, the court should deny the motion to dismiss. In addition, where the bottom line was omitted in a corrective disclosure, that fact should count against defendants. And, finally, a presumption of materiality should be applied where the bottom line is subsequently made public and the market reacts negatively to that disclosure. This approach is more in line with general materiality analysis and will better serve the interests of full and fair disclosure than the current approach, which asks only whether the data necessary to calculate the bottom line was disclosed.

In *Merck*, the Third Circuit upheld a disclosure that required investors to “read[] between the lines”²⁷⁹ to discover that Merck’s main subsidiary had counted \$5.54 billion in revenue that it never actually received.²⁸⁰ Many would agree that such disclosure is neither full nor fair. The Reasonably Available Data rule proposed here would help ensure courts take a more analytically rigorous approach in deciding whether such omissions are immaterial as a matter of law.

279. *In re Merck & Co. Sec. Litig.*, 432 F.3d 261, 263 (2005).

280. *Id.* at 265.

